WATTS WATER TECHNOLOGIES INC
Form 10-Q
August 09, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended July 1, 2012

or

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to

Commission file number 001-11499

WATTS WATER TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**04-2916536**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
815 Chestnut Street, North Andover, MA	**01845**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number, Including Area Code: **(978) 688-1811**

(Former Name, Former Address and Former Fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at July 31, 2012**
Class A Common Stock, $0.10 par value	27,764,589
Class B Common Stock, $0.10 par value	6,953,680

Table of Contents

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

INDEX

Part I. Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets at July 1, 2012 and December 31, 2011 (unaudited)

Consolidated Statements of Operations for the Second Quarters and Six Months Ended July 1, 2012 and July 3, 2011 (unaudited)

Consolidated Statements of Comprehensive Income for the Second Quarters and Six Months Ended July 1, 2012 and July 3, 2011 (unaudited)

Consolidated Statements of Cash Flows for the Six Months Ended July 1, 2012 and July 3, 2011 (unaudited)

Notes to Consolidated Financial Statements (unaudited)

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

Part II. Other Information

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 6. Exhibits

Signatures

Exhibit Index

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Amounts in millions, except share information)

(Unaudited)

	July 1, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	**$ 167.8**	$ 250.6
Short-term investment securities	**4.1**	4.1
Trade accounts receivable, less allowance for doubtful accounts of $9.7 million at July 1, 2012 and $9.1 million at December 31, 2011	**223.3**	207.1
Inventories, net:		
Raw materials	**104.6**	107.7
Work in process	**22.3**	28.7
Finished goods	**159.9**	147.8
Total Inventories	**286.8**	284.2
Prepaid expenses and other assets	**35.8**	26.6
Deferred income taxes	**27.8**	28.3
Assets held for sale	**14.7**	4.6
Total Current Assets	**760.3**	805.5
PROPERTY, PLANT AND EQUIPMENT:		
Property, plant and equipment, at cost	**487.6**	494.8
Accumulated depreciation	**(275.5)**	(268.1)
Property, plant and equipment, net	**212.1**	226.7
OTHER ASSETS:		
Goodwill	**490.5**	490.4
Intangible assets, net	**149.5**	154.6
Deferred income taxes	**9.1**	10.2
Other, net	**9.8**	10.1
TOTAL ASSETS	$ **1,631.3**	$ 1,697.5
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ **125.9**	$ 126.5
Accrued expenses and other liabilities	**117.4**	109.2
Accrued compensation and benefits	**39.5**	45.9
Current portion of long-term debt	**77.0**	2.0
Total Current Liabilities	**359.8**	283.6
LONG-TERM DEBT, NET OF CURRENT PORTION	**308.1**	397.4
DEFERRED INCOME TAXES	**55.9**	58.2
OTHER NONCURRENT LIABILITIES	**38.4**	38.5
STOCKHOLDERS EQUITY:		
Preferred Stock, $0.10 par value; 5,000,000 shares authorized; no shares issued or outstanding		

Class A Common Stock, $0.10 par value; 80,000,000 shares authorized; 1 vote per share; issued and outstanding, 27,844,816 shares at July 1, 2012 and 29,471,414 shares at December 31, 2011		**2.8**		2.9
Class B Common Stock, $0.10 par value; 25,000,000 shares authorized; 10 votes per share; issued and outstanding, 6,953,680 shares at July 1, 2012 and at December 31, 2011		**0.7**		0.7
Additional paid-in capital		**432.3**		420.1
Retained earnings		**475.2**		515.1
Accumulated other comprehensive loss		**(41.9)**		(19.0)
Total Stockholders Equity		**869.1**		919.8
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	**1,631.3**	$	1,697.5

See accompanying notes to consolidated financial statements.

Table of Contents

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in millions, except per share information)

(Unaudited)

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
Net sales	$ **371.1**	$ 375.7	**$ 735.3**	$ 705.6
Cost of goods sold	**239.3**	245.4	**473.9**	454.3
GROSS PROFIT	**131.8**	130.3	**261.4**	251.3
Selling, general & administrative expenses	**96.9**	98.2	**197.9**	195.2
Restructuring and other charges	**1.2**	5.5	**2.9**	6.6
OPERATING INCOME	**33.7**	26.6	**60.6**	49.5
Other (income) expense:				
Interest income	**(0.2)**	(0.2)	**(0.4)**	(0.5)
Interest expense	**6.1**	6.7	**12.3**	12.6
Other expense, net		0.6	**(0.9)**	0.7
Total other expense	**5.9**	7.1	**11.0**	12.8
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	**27.8**	19.5	**49.6**	36.7
Provision for income taxes	**9.3**	6.6	**15.4**	12.7
NET INCOME FROM CONTINUING OPERATIONS	**18.5**	12.9	**34.2**	24.0
Income from discontinued operations, net of taxes		1.7		1.7
NET INCOME	$ **18.5**	$ 14.6	**$ 34.2**	$ 25.7
BASIC EPS				
Net income per share:				
Continuing operations	**$ 0.51**	$ 0.34	**$ 0.93**	$ 0.64
Discontinued operations		0.05		0.05
NET INCOME	**$ 0.51**	$ 0.39	**$ 0.93**	$ 0.69
Weighted average number of shares	**36.5**	37.6	**36.7**	37.6
DILUTED EPS				
Net income per share:				
Continuing operations	**$ 0.51**	$ 0.34	**$ 0.93**	**$** 0.64
Discontinued operations		0.05		0.05
NET INCOME	**$ 0.51**	$ 0.39	**$ 0.93**	$ 0.68
Weighted average number of shares	**36.6**	37.8	**36.8**	37.7
Dividends per share	**$ 0.11**	$ 0.11	**$ 0.22**	$ 0.22

See accompanying notes to consolidated financial statements.

Table of Contents

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Amounts in millions)

(Unaudited)

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
Net income	**$ 18.5**	$ 14.6	**$ 34.2**	$ 25.7
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	**(39.7)**	14.7	**(23.2)**	48.7
Defined benefit pension plans:				
Amortization of prior service cost included in net periodic pension cost		0.1		0.2
Amortization of net losses included in net periodic pension cost	**0.1**	0.7	**0.3**	1.4
Defined benefit pension plans	**0.1**	0.8	**0.3**	1.6
Other comprehensive income (loss), net of tax	**(39.6)**	15.5	**(22.9)**	50.3
Comprehensive income (loss)	**$ (21.1)**	$ 30.1	**$ 11.3**	$ 76.0

See accompanying notes to consolidated financial statements.

Table of Contents

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in millions)

(Unaudited)

	Six Months Ended			
		July 1, 2012		**July 3, 2011**
OPERATING ACTIVITIES				
Net income	**$**	**34.2**	$	25.7
Less: Income from discontinued operations, net of taxes				1.7
Net income from continuing operations		**34.2**		24.0
Adjustments to reconcile net income from continuing operations to net cash provided by continuing operating activities:				
Depreciation		**16.7**		16.1
Amortization		**8.4**		9.3
Stock-based compensation		**2.5**		5.8
Deferred income taxes benefit		**(0.5)**		(4.7)
Loss on disposal and impairment of property, plant and equipment and other		**0.4**		0.5
Changes in operating assets and liabilities, net of effects from business acquisitions and divestitures:				
Accounts receivable		**(21.4)**		(14.0)
Inventories		**(9.7)**		(14.7)
Prepaid expenses and other assets		**(9.2)**		(4.0)
Accounts payable, accrued expenses and other liabilities		**2.5**		2.4
Net cash provided by continuing operations		**23.9**		20.7
INVESTING ACTIVITIES				
Additions to property, plant and equipment		**(9.6)**		(12.0)
Proceeds from the sale of property, plant and equipment		**1.0**		0.6
Purchase of short-term investment securities				(4.1)
Proceeds from the sale of short-term investment securities				4.1
Business acquisitions, net of cash acquired		**(17.5)**		(162.9)
Net cash used in investing activities		**(26.1)**		(174.3)
FINANCING ACTIVITIES				
Proceeds from long-term debt		**9.2**		184.0
Payments of long-term debt		**(22.8)**		(99.9)
Payment of capital leases and other		**(1.2)**		(1.3)
Proceeds from share transactions under employee stock plans		**6.0**		3.0
Tax benefit of stock awards exercised		**0.4**		0.4
Dividends		**(8.2)**		(8.3)
Payments to repurchase common stock		**(63.2)**		
Net cash provided by (used in) financing activities		**(79.8)**		77.9
Effect of exchange rate changes on cash and cash equivalents		**(0.8)**		13.2
DECREASE IN CASH AND CASH EQUIVALENTS		**(82.8)**		(62.5)
Cash and cash equivalents at beginning of year		**250.6**		329.2
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$**	**167.8**	$	266.7
NON-CASH INVESTING AND FINANCING ACTIVITIES				
Acquisition of businesses:				
Fair value of assets acquired	**$**	**27.7**	$	218.8

Cash paid, net of cash acquired		**17.5**		162.9
Liabilities assumed	**$**	**10.2**	$	55.9
Acquisition of fixed assets under financing agreements	**$**	**0.6**	$	4.3
Issuance of stock under management stock purchase plan	**$**	**0.4**	$	0.4
CASH PAID FOR:				
Interest	**$**	**12.5**	$	12.2
Income taxes	**$**	**14.0**	$	20.1

See accompanying notes to consolidated financial statements.

Table of Contents

WATTS WATER TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the Watts Water Technologies, Inc. (the Company) Consolidated Balance Sheet as of July 1, 2012, the Consolidated Statements of Operations for the second quarter and six months ended July 1, 2012 and July 3, 2011, the Consolidated Statements of Comprehensive Income for the second quarter and six months ended July 1, 2012 and July 3, 2011, and the Consolidated Statements of Cash Flows for the six months ended July 1, 2012 and July 3, 2011.

The balance sheet at December 31, 2011 has been derived from the audited consolidated financial statements at that date. The accounting policies followed by the Company are described in the Company s Annual Report on Form 10-K for the year ended December 31, 2011. The financial statements included in this report should be read in conjunction with the consolidated financial statements and notes included in the Annual Report on Form 10-K for the year ended December 31, 2011. Operating results for the interim period presented are not necessarily indicative of the results to be expected for the year ending December 31, 2012.

The Company operates on a 52-week fiscal year ending on December 31st. Any quarterly or six- month data contained in this Quarterly Report on Form 10-Q generally reflect the results of operations for a 13-week period or 26-week period, respectively.

Certain amounts in the 2011 consolidated financial statements have been reclassified to permit comparison with the 2012 presentation. These reclassifications had no effect on reported results of operations or stockholders equity.

2. Accounting Policies

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Goodwill and Long-Lived Assets

The changes in the carrying amount of goodwill by geographic segment are as follows:

	Gross Balance				Accumulated Impairment Losses			Net Goodwill
	Balance January 1, 2011	Acquired During the Period	Foreign Currency Translation and Other	Balance July 3, 2011	Balance January 1, 2011	Impairment Loss During the Period	Balance July 3, 2011	July 3, 2011
				(in millions)				
North America	$ 213.8	$ 2.5	$	$ 216.3	$ (22.0)	$	$ (22.0)	$ 194.3
Europe, Middle East and Africa (EMEA)	228.1	62.5	17.2	307.8				307.8
Asia	8.1	4.3	0.2	12.6				12.6
Total	$ 450.0	$ 69.3	$ 17.4	$ 536.7	$ (22.0)	$	$ (22.0)	$ 514.7

	Gross Balance				Accumulated Impairment Losses			Net Goodwill
	Balance January 1, 2012	Acquired During the Period	Foreign Currency Translation and Other	Balance July 1, 2012	Balance January 1, 2012	Impairment Loss During the Period	Balance July 1, 2012	July 1, 2012
				(in millions)				
North America	**$ 215.6**	**$ 13.1**	**$ (2.1)**	**$ 226.6**	**$ (23.2)**	**$**	**$ (23.2)**	**$ 203.4**
EMEA	**285.3**		**(10.8)**	**274.5**				**274.5**
Asia	**12.7**		**(0.1)**	**12.6**				**12.6**
Total	**$ 513.6**	**$ 13.1**	**$ (13.0)**	**$ 513.7**	**$ (23.2)**	**$**	**$ (23.2)**	**$ 490.5**

On January 31, 2012, the Company completed the acquisition of tekmar Control Systems (tekmar) in a share purchase transaction. A designer and manufacturer of control systems used in heating, ventilation, and air conditioning applications, tekmar is expected to enhance the Company s hydronic systems product offerings in the U.S. and Canada. The initial purchase price paid was CAD $18.0 million, with post-closing adjustments related to working capital and an earn-out based on the attainment of certain future earnings

Table of Contents

levels. The total purchase price will not exceed CAD $26.2 million. The Company is accounting for the transaction as a business combination. The Company completed a preliminary purchase price allocation that resulted in the recognition of $13.1 million in goodwill and $10.1 million in intangible assets. Intangible assets consist primarily of acquired technology with an estimated life of 10 years, distributor relationships with an estimated life of 7 years, and a trade name with an estimated life of 20 years. The goodwill is not expected to be deductible for tax purposes.

Goodwill and indefinite-lived intangible assets are tested for impairment at least annually or more frequently if events or circumstances indicate that it is more likely than not that they might be impaired, such as from a change in business conditions. The Company performs its annual impairment assessment of goodwill and indefinite-lived intangible assets in the fourth quarter of each year.

As of October 30, 2011, the annual impairment analysis date, the fair value of the Company s Europe, Middle East and Africa (EMEA) reporting unit exceeded the carrying value by approximately 9%. Operating results for the EMEA reporting unit have been hindered by the downturn in the economic environment in Europe and continued to fall below expectations during the six months ended July 1, 2012, triggering the decision to update the impairment analysis. As a result of the updated fair value assessment, it was determined that the fair value of the EMEA reporting unit continues to exceed its carrying value, a result of a decrease in discount rate and a reduction of net debt offset by lower short-term projections. The Company also performed an analysis on the long-lived assets in the EMEA reporting unit as a result of the triggering event and concluded that these assets were not impaired.

Should the EMEA reporting unit s operating results decline further because the European marketplace deteriorates beyond our current expectations or should interest rates increase significantly, then the reporting unit s goodwill may be at risk for impairment in the future. The EMEA reporting unit s goodwill balance as of July 1, 2012 was $202.7 million.

Intangible assets with estimable lives and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability of intangible assets with estimable lives and other long-lived assets are measured by a comparison of the carrying amount of an asset or asset group to future net undiscounted pretax cash flows expected to be generated by the asset or asset group. If these comparisons indicate that an asset is not recoverable, the impairment loss recognized is the amount by which the carrying amount of the asset or asset group exceeds the related estimated fair value. Estimated fair value is based on either discounted future pretax operating cash flows or appraised values, depending on the nature of the asset. The Company determines the discount rate for this analysis based on the weighted average cost of capital based on the market and guideline public companies for the related business and does not allocate interest charges to the asset or asset group being measured. Judgment is required to estimate future operating cash flows.

Intangible assets include the following:

	July 1, 2012			December 31, 2011		
	Gross Carrying Amount	**Accumulated Amortization**	**Net Carrying Amount**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
			(in millions)			
Patents	**$ 16.3**	**$ (11.2)**	**$ 5.1**	$ 16.5	$ (10.8)	$ 5.7
Customer relationships	**132.1**	**(63.9)**	**68.2**	135.8	(57.7)	78.1
Technology	**28.1**	**(8.2)**	**19.9**	19.8	(7.1)	12.7

Trade Names		**13.0**		**(1.3)**		**11.7**		13.4		(0.8)		12.6
Other		**8.6**		**(5.5)**		**3.1**		8.5		(5.4)		3.1
Total amortizable intangibles		**198.1**		**(90.1)**		**108.0**		194.0		(81.8)		112.2
Indefinite-lived intangible assets		**41.5**				**41.5**		42.4				42.4
Total	**$**	**239.6**	**$**	**(90.1)**	**$**	**149.5**	$	236.4	$	(81.8)	$	154.6

Aggregate amortization expense for amortizable intangible assets for the second quarters of 2012 and 2011 was $4.2 million and $5.3 million, respectively, and for the first six months of 2012 and 2011 was $8.4 million and $9.3 million, respectively. Additionally, future amortization expense for the next five years on amortizable intangible assets is expected to be approximately $7.6 million for the remainder of 2012, $15.0 million for 2013, $14.8 million for 2014, $14.5 million for 2015 and $14.1 million for 2016. Amortization expense is recorded on a straight-line basis over the estimated useful lives of the intangible assets. The weighted-average remaining life of total amortizable intangible assets is 10.0 years. Patents, customer relationships, technology, trade names and other amortizable intangibles have weighted-average remaining lives of 6.9 years, 7.0 years, 12.2 years, 12.1 years and 42.1 years, respectively. Intangible assets not subject to amortization consist of certain trademarks and trade names.

Stock-Based Compensation

The Company maintains three stock incentive plans under which key employees and non-employee members of the Company s Board of Directors have been granted incentive stock options (ISOs) and nonqualified stock options (NSOs) to purchase the Company s Class A Common Stock. Only one plan, the 2004 Stock Incentive Plan, is currently available for the grant of new stock options, which are currently being granted only to employees. Under the 2004 Stock Incentive Plan, options become exercisable over a four-year period at the rate of 25% per year and expire ten years after the grant date. ISOs and NSOs granted under the plans may have exercise

Table of Contents

prices of not less than 100% and 50% of the fair market value of the Class A Common Stock on the date of grant, respectively. The Company s current practice is to grant all options at fair market value on the grant date. The Company did not issue any stock options during the first six months of 2012 and 2011.

The Company has also granted shares of restricted stock to key employees and stock awards to non-employee members of the Company s Board of Directors under the 2004 Stock Incentive Plan, which vest either immediately, or over a three-year period at the rate of one-third per year. The restricted stock awards are amortized to expense on a straight-line basis over the vesting period. The Company did not issue any restricted stock in the first six months of 2012 and issued 1,400 shares of restricted stock in the first six months of 2011.

The Company also has a Management Stock Purchase Plan that allows for the purchase of restricted stock units (RSUs) by key employees. On an annual basis, key employees may elect to receive a portion of their annual incentive compensation in RSUs instead of cash. Each RSU represents one share of Class A Common Stock and is purchased by the employee at 67% of the fair market value of the Company s Class A Common Stock on the date of grant. RSUs vest annually over a three-year period from the grant date and receipt of the shares underlying RSUs is deferred for a minimum of three years or such greater number of years as is chosen by the employee. An aggregate of 2,000,000 shares of Class A Common Stock may be issued under the Management Stock Purchase Plan. The Company granted 63,739 RSUs and 96,454 RSUs in the first six months of 2012 and 2011, respectively.

The fair value of each RSU issued under the Management Stock Purchase Plan is estimated on the date of grant, using the Black-Scholes-Merton Model, based on the following weighted average assumptions:

	2012	**2011**
Expected life (years)	**3.0**	3.0
Expected stock price volatility	**38.3%**	44.9%
Expected dividend yield	**1.1%**	1.2%
Risk-free interest rate	**0.4%**	1.2%

The above assumptions were used to determine the weighted average grant-date fair value of RSUs of $15.68 and $16.25 in 2012 and 2011, respectively.

A more detailed description of each of these stock and stock option plans can be found in Note 12 of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

On May 23, 2012, William C. McCartney provided notice of his intention to retire as Chief Financial Officer of the Company. On June 14, 2012, the Company entered into a retention agreement with Mr. McCartney. Pursuant to the retention agreement, Mr. McCartney will continue employment with the Company until December 14, 2012 and will assist the Company in identifying a successor and transitioning his responsibilities and duties to the new Chief Financial Officer. Pursuant to Mr. McCartney fulfilling his duties under the retention agreement, the Company will record a pre-tax charge of approximately $1.5 million over the retention period, consisting of expected cash payments of $0.7 million and a non-cash charge of $0.8 million for the modification of stock options and restricted stock awards. In addition, Mr. McCartney will receive a performance bonus he would have been entitled to had he been employed by the Company through December 31, 2012. The charge recorded in the second quarter related to the retention agreement was immaterial.

On January 26, 2011, Patrick S. O Keefe resigned from his positions as Chief Executive Officer, President and Director. Pursuant to a separation agreement, the Company recorded a charge of $6.3 million, consisting of $3.3 million in expected cash severance and a non-cash charge of $3.0 million for the modification of stock options and restricted stock awards.

Shipping and Handling

The Company s shipping costs included in selling, general and administrative expenses were $8.9 million and $9.9 million for the second quarters of 2012 and 2011, respectively, and were $18.8 million and $18.7 million for the first six months of 2012 and 2011, respectively.

Research and Development

Research and development costs included in selling, general and administrative expenses were $5.3 million and $5.7 million for the second quarters of 2012 and 2011, respectively, and were $10.7 million for both the first six months of 2012 and 2011, respectively.

Taxes, Other than Income Taxes

Taxes assessed by governmental authorities on sale transactions are recorded on a net basis and excluded from sales in the Company s consolidated statements of operations.

Table of Contents

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

New Accounting Standards

In December 2011, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting guidance for disclosure of offsetting assets and liabilities and related arrangements. The amendment expands the disclosure requirements in that entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. The amendment is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013, and shall be applied retrospectively. The Company does not expect the adoption of this accounting pronouncement will have a material impact on its financial statements.

In July 2012, the FASB issued an amendment to the requirements for indefinite-lived intangible asset impairment testing. The Company has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If, after assessing the totality of events or circumstances, the Company determines it is more likely than not that the fair value of an indefinite-lived intangible asset is greater than its carrying amount, then performing the impairment test is unnecessary. The Company intends to adopt this new standard effective with its annual impairment testing date of October 30, for the year ending December 31, 2012.

3. Discontinued Operations and Assets Held For Sale

In the first quarter of 2010, the Company recorded an estimated reserve of $5.3 million in discontinued operations in connection with its investigation of potential violations of the Foreign Corrupt Practices Act (FCPA) at Watts Valve (Changsha) Co., Ltd. (CWV), a former indirect wholly-owned subsidiary of the Company in China. On October 13, 2011, the Company entered into a settlement for $3.8 million with the Securities and Exchange Commission to resolve allegations concerning potential violations of the FCPA at CWV. During the quarter ended July 3, 2011, the Company revised the reserve to $3.8 million based on the pending settlement. See Note 3 of the Company s Annual Report on Form 10-K for the year ended December 31, 2011.

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
	(in millions)			
Reserve release - FCPA matter (CWV)	**$**	$ 1.7	**$**	$ 1.7
Gain on disposal TEAM		0.3		0.3

Income (loss) before income taxes			2.0			2.0
Income tax expense			0.3			0.3
Income from discontinued operations, net of taxes	**$**	$	1.7	**$**	$	1.7

During the quarter ended July 1, 2012, the Company s Board of Directors approved the disposal of an operation within the Company s North America segment. The Company evaluated the fair value less cost to sell the net assets and determined that the fair value exceeded the carrying value. The Company recorded the net assets of $10.9 million, representing gross assets of $14.0 million less liabilities of $3.1 million, as assets held for sale. The revenues and results of operations are not material to the Company. The Company will not have continuing involvement after a sale is completed.

4. Financial Instruments and Derivative Instruments

The Company measures certain financial assets and liabilities at fair value on a recurring basis, including foreign currency derivatives, deferred compensation plan assets and related liability, and contingent consideration. There were no cash flow hedges as of July 1, 2012. The fair values of these certain financial assets and liabilities were determined using the following inputs at July 1, 2012 and December 31, 2011:

Table of Contents

	Total		Fair Value Measurements at July 1, 2012 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)
			(in millions)				
Assets							
Plan asset for deferred compensation(1)	$	4.1	$	4.1	$	$	
Total assets	$	4.1	$	4.1	$	$	
Liabilities							
Plan liability for deferred compensation(2)	$	4.1	$	4.1	$	$	
Contingent consideration(3)		6.1					6.1
Total liabilities	$	10.2	$	4.1	$	$	6.1

	Total		Fair Value Measurements at December 31, 2011 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)
			(in millions)				
Assets							
Plan asset for deferred compensation(1)	$	4.0	$	4.0	$	$	
Total assets	$	4.0	$	4.0	$	$	
Liabilities							
Plan liability for deferred compensation(2)	$	4.0	$	4.0	$	$	
Contingent consideration(3)		1.1					1.1
Total liabilities	$	5.1	$	4.0	$	$	1.1

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(1) Included in other, net on the Company s consolidated balance sheet.

(2) Included in accrued compensation and benefits on the Company s consolidated balance sheet.

(3) Included in other noncurrent liabilities and accrued expenses and other liabilities on the Company s consolidated balance sheet.

The table below provides a summary of the changes in fair value of all financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period December 31, 2011 to July 1, 2012.

	Balance December 31, 2011	Purchases, sales, settlements, net	Total realized and unrealized gains (losses) included in: Earnings	Total realized and unrealized gains (losses) included in: Comprehensive income	Balance July 1, 2012
			(in millions)		
Contingent consideration	$ 1.1	$ 5.1	$ 0.1	$ (0.2)	$ 6.1

In 2010, a contingent liability of $1.9 million was recognized as an estimate of the acquisition date fair value of the contingent consideration in the BRAE acquisition. This liability was classified as Level 3 under the fair value hierarchy as it was based on the weighted probability of achievement of a future performance metric as of the date of the acquisition, which was not observable in the market. During the year ended December 31, 2011, the estimate of the fair value of the contingent consideration was reduced to $1.1 million based on the revised probability of achievement of the future performance metric. Failure to meet the performance metric would reduce this liability to zero, while complete achievement would increase this liability to the full remaining purchase price of $4.8 million.

In connection with the tekmar Control Systems acquisition in 2012, a contingent liability of $5.1 million was recognized as the estimate of the acquisition date fair value of the contingent consideration (see Note 12). This liability was classified as Level 3 under the fair value hierarchy as it was based on the probability of achievement of a future performance metric as of the date of the acquisition, which was not observable in the market. Failure to meet the performance metrics would reduce this liability to zero; while complete achievement would increase this liability to the full remaining purchase price of CAD $8.2 million.

Table of Contents

Short-term investment securities as of July 1, 2012 consist of a certificate of deposit with a remaining maturity of greater than three months at the date of purchase, for which the carrying amount is a reasonable estimate of fair value.

Cash equivalents consist of instruments with remaining maturities of three months or less at the date of purchase and consist primarily of certificates of deposit and money market funds, for which the carrying amount is a reasonable estimate of fair value.

The Company uses financial instruments from time to time to enhance its ability to manage risk, including foreign currency and commodity pricing exposures, which exist as part of its ongoing business operations. The use of derivatives exposes the Company to counterparty credit risk for nonperformance and to market risk related to changes in currency exchange rates and commodity prices. The Company manages its exposure to counterparty credit risk through diversification of counterparties. The Company s counterparties in derivative transactions are substantial commercial banks with significant experience using such derivative instruments. The impact of market risk on the fair value and cash flows of the Company s derivative instruments is monitored and the Company restricts the use of derivative financial instruments to hedging activities. The Company does not enter into contracts for trading purposes nor does the Company enter into any contracts for speculative purposes. The use of derivative instruments is approved by senior management under written guidelines.

The Company has exposure to a number of foreign currency rates, including the Canadian Dollar, the Euro, the Chinese Yuan and the British Pound. To manage this risk, the Company generally uses a layering methodology whereby at the end of any quarter, the Company has generally entered into forward exchange contracts which hedge approximately 50% of the projected intercompany purchase transactions for the next twelve months. The Company primarily uses this strategy for the purchases between Canada and the U.S. The average volume of contracts can vary but generally is approximately $2 million to $15 million in open contracts at the end of any given quarter. At July 1, 2012, the Company had contracts for notional amounts aggregating approximately $2.0 million. The Company accounts for the forward exchange contracts as an economic hedge. Realized and unrealized gains and losses on the contracts are recognized in other (income) expense in the consolidated statement of operations. These contracts do not subject the Company to significant market risk from exchange movement because they offset gains and losses on the related foreign currency denominated transactions. The fair value of these contracts as of July 1, 2012 was not material.

Fair Value

The carrying amounts of cash and cash equivalents, short-term investments, trade receivables and trade payables approximate fair value because of the short maturity of these financial instruments.

The fair values of the Company s 5.47% senior notes due 2013, 5.85% senior notes due 2016 and 5.05% senior notes due 2020, are based on a discounted cash flow model using like industrial companies, the Company s credit metrics, the Company s size, as well as current market interest rates quoted in active markets and are classified within Level 2 of the valuation hierarchy. The fair value of the Company s variable rate debt approximates its carrying value. The carrying amount and the estimated fair market value of the Company s long-term debt, including the current portion, are as follows:

	July 1, 2012	December 31, 2011
	(in millions)	

Carrying amount	**$**	**385.1**	$	399.4
Estimated fair value	**$**	**422.7**	$	440.5

5. Restructuring and Other Charges

The Company s Board of Directors approves all major restructuring programs that involve the discontinuance of product lines or the shutdown of facilities. From time to time, the Company takes additional restructuring actions, including involuntary terminations that are not part of a major program. The Company accounts for these costs in the period that the individual employees are notified or the liability is incurred. These costs are included in restructuring and other charges in the Company s consolidated statements of operations. In April 2011, the Board approved an integration program in association with the acquisition of Danfoss Socla S.A.S. (Socla). The program was designed to integrate certain operations and management structures of Socla with a total estimated pre-tax cost of $6.4 million with costs being incurred through 2012. As of July 1, 2012, the Company revised its forecast to $4.4 million due to lower than expected severance costs.

The Company also periodically initiates other actions which are not part of a major program. In 2011, the Company initiated restructuring activities with respect to the Company s operating facilities in Europe, which included the closure of a facility. The Europe restructuring activities are expected to include pre-tax costs of approximately $2.6 million, including costs for severance and shut-down costs. The total net after-tax charge is $1.8 million with costs being incurred through 2012. In 2012, the Company commenced restructuring activities in North America to relocate certain production activities, which include the closure of two manufacturing sites occurring through 2013. Total expected costs are $2.8 million, including severance and shutdown costs. The net after tax charge of $1.8 million will be incurred through the middle of 2013.

Table of Contents

A summary of the pre-tax cost by restructuring program is as follows:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
	(in millions)			
Restructuring costs:				
2010 Actions	**$ 0.1**	$ 1.8	**$ 0.1**	$ 2.7
2011 Actions	**0.1**	3.4	**0.6**	3.6
Other Actions	**0.9**		**1.6**	
Total restructuring charges	**1.1**	5.2	**2.3**	6.3
Other charges related to impairments	**0.1**	0.3	**0.6**	0.3
Total restructuring and other charges	**$ 1.2**	$ 5.5	**$ 2.9**	$ 6.6

The Company recorded net pre-tax restructuring and other charges in its business segments as follows:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
	(in millions)			
North America	**$ 0.4**	$	**$ 0.8**	$ 0.1
EMEA	**0.8**	5.3	**2.1**	6.3
Asia.		0.2		0.2
Total	**$ 1.2**	$ 5.5	**$ 2.9**	$ 6.6

2011 Actions

The following table summarizes the total expected, incurred and remaining pre-tax severance costs for the 2011 Socla integration program:

Reportable Segment	Total Expected Costs	Incurred through July 1, 2012	Remaining Costs at July 1, 2012
		(in millions)	
EMEA	$ 4.2	$ 3.5	**$ 0.7**
Asia	0.2	0.2	
Total	$ 4.4	$ 3.7	**$ 0.7**

The Company expects to spend the remaining costs by the end of 2012.

Details of the Company s 2011 Socla integration reserves for severance for the six months ended July 1, 2012 are as follows:

		Six Months Ended July 1, 2012 (in millions)
Balance at December 31, 2011	$	0.4
Net pre-tax restructuring charges		0.5
Utilization and foreign currency impact		(0.3)
Balance at April 1, 2012	$	0.6
Net pre-tax restructuring charges		**0.1**
Utilization and foreign currency impact		**(0.6)**
Balance at July 1, 2012	**$**	**0.1**

The Company expects to exhaust the remaining reserve by the end of 2012.

Table of Contents

The following table summarizes expected, incurred and remaining severance costs for 2011 Socla integration actions:

		Incurred through July 1, 2012 (in millions)
Expected costs	$	4.4
Costs incurred 2011		(3.1)
Costs incurred quarter ended April 1, 2012		(0.5)
Costs incurred quarter ended July 1, 2012		**(0.1)**
Remaining costs at July 1, 2012	**$**	**0.7**

6. Earnings per Share

The following tables set forth the reconciliation of the calculation of earnings per share:

	For the Second Quarter Ended July 1, 2012					For the Second Quarter Ended July 3, 2011				
	Income (Numerator)		Shares (Denominator)	Per Share Amount		Income (Numerator)		Shares (Denominator)	Per Share Amount	
	(amounts in millions, except per share amounts)									
Basic EPS										
Net income:										
Continuing operations	**$**	**18.5**	**36.5**	**$**	**0.51**	$	12.9	37.6	$	0.34
Discontinued operations							1.7			0.05
Net income	**$**	**18.5**		**$**	**0.51**	$	14.6		$	0.39
Effect of dilutive securities										
Common stock equivalents			**0.1**					0.2		
Diluted EPS										
Net income:										
Continuing operations	**$**	**18.5**		**$**	**0.51**	$	12.9		$	0.34
Discontinued operations							1.7			0.05
Net income	**$**	**18.5**	**36.6**	**$**	**0.51**	$	14.6	37.8	$	0.39

Options to purchase 0.4 million and 0.3 million shares of Class A Common Stock were outstanding during the second quarters of 2012 and 2011, respectively, but were not included in the computation of diluted EPS because to do so would be anti-dilutive.

	For the Six Months Ended July 1, 2012					For the Six Months Ended July 3, 2011				
	Income (Numerator)		Shares (Denominator)	Per Share Amount		Income (Numerator)		Shares (Denominator)	Per Share Amount	
	(amounts in millions, except per share amounts)									
Basic EPS										
Net income:										
Continuing operations	**$**	**34.2**	**36.7**	**$**	**0.93**	$	24.0	37.6	$	0.64
Discontinued operations							1.7			0.05

Net income	**$ 34.2**		**$ 0.93**	$ 25.7		$ 0.69
Effect of dilutive securities						
Common stock equivalents		**0.1**			0.1	
Diluted EPS						
Net income:						
Continuing operations	**$ 34.2**		**$ 0.93**	$ 24.0		$ 0.64
Discontinued operations				1.7		0.05
Net income	**$ 34.2**	**36.8**	**$ 0.93**	$ 25.7	37.7	$ 0.68

Options to purchase 0.4 million and 0.3 million shares of Class A Common Stock were outstanding during the first six months of 2012 and 2011, respectively, but were not included in the computation of diluted EPS because to do so would be anti-dilutive.

On May 16, 2012, the Board of Directors authorized a stock repurchase program of up to two million shares of the Company s Class A Common Stock. During the quarter ended July 1, 2012, the Company repurchased approximately 1.9 million shares of Class A common stock at a cost of approximately $63.2 million. The stock repurchase program was completed in July 2012.

Table of Contents

7. Segment Information

The Company operates in three geographic segments: North America, EMEA, and Asia. Each of these segments is managed separately and has separate financial results that are reviewed by the Company s chief operating decision-maker. All intercompany sales transactions have been eliminated. Sales by region are based upon location of the entity recording the sale. The accounting policies for each segment are the same as those described in the summary of significant accounting policies.

The following is a summary of the Company s significant accounts and balances by segment, reconciled to the consolidated totals:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
	(in millions)			
Net Sales				
North America	**$ 221.8**	$ 212.0	**$ 431.8**	$ 414.1
EMEA	**142.8**	157.8	**292.0**	281.8
Asia	**6.5**	5.9	**11.5**	9.7
Consolidated net sales	**$ 371.1**	$ 375.7	**$ 735.3**	$ 705.6
Operating income (loss)				
North America	**$ 26.7**	$ 26.3	**$ 46.9**	$ 53.0
EMEA	**12.0**	6.9	**24.8**	16.6
Asia	**2.1**	0.9	**3.5**	1.7
Subtotal reportable segments	**40.8**	34.1	**75.2**	71.3
Corporate (*)	**(7.1)**	(7.5)	**(14.6)**	(21.8)
Consolidated operating income	**33.7**	26.6	**60.6**	49.5
Interest income	**0.2**	0.2	**0.4**	0.5
Interest expense	**(6.1)**	(6.7)	**(12.3)**	(12.6)
Other		(0.6)	**0.9**	(0.7)
Income from continuing operations before income taxes	**27.8**	$ 19.5	**$ 49.6**	$ 36.7
Capital Expenditures				
North America	**$ 1.8**	$ 1.9	**$ 4.4**	$ 5.3
EMEA	**2.4**	3.2	**4.6**	6.3
Asia	**0.5**	0.3	**0.6**	0.4
Consolidated capital expenditures	**$ 4.7**	$ 5.4	**$ 9.6**	$ 12.0
Depreciation and Amortization				
North America	**$ 5.2**	$ 5.2	**$ 10.0**	$ 9.6
EMEA	**6.8**	8.4	**14.1**	14.8
Asia	**0.5**	0.5	**1.0**	1.0
Consolidated depreciation and amortization	**$ 12.5**	$ 14.1	**$ 25.1**	$ 25.4
Identifiable Assets (at end of period)				
North America			**$ 790.0**	$ 844.9

EMEA		**750.5**		948.8
Asia		**90.8**		85.1
Discontinued operations				1.6
Consolidated identifiable assets	**$**	**1,631.3**	$	1,880.4
Property, plant and equipment, net (at end of period)				
North America	**$**	**73.7**	$	83.8
EMEA		**123.9**		153.1
Asia		**14.5**		15.3
Consolidated property, plant and equipment, net	**$**	**212.1**	$	252.2

* Corporate expenses are primarily for administrative compensation expense, internal controls costs, professional fees, including legal and audit expenses, shareholder services and benefit administration costs. These costs are not allocated to the geographic segments as they are viewed as corporate functions that support all activities.

The above operating segments are presented on a basis consistent with the presentation included in the Company s December 31, 2011 consolidated financial statements included in its Annual Report on Form 10-K.

Table of Contents

The following includes U.S. net sales and U.S. property, plant and equipment of the Company s North America segment:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
	(in millions)			
U.S. net sales	**$ 199.7**	$ 192.5	**$ 389.7**	$ 375.4
U.S. property, plant and equipment (at end of period)			**$ 71.6**	$ 78.6

The following includes intersegment sales for North America, EMEA and Asia:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
	(in millions)			
Intersegment Sales				
North America	**$ 1.2**	$ 0.8	**$ 2.6**	$ 1.7
EMEA	**2.0**	2.3	**4.6**	4.2
Asia	**35.3**	37.2	**66.4**	67.9
Intersegment sales	**$ 38.5**	$ 40.3	**$ 73.6**	$ 73.8

The North America segment includes $14.7 million in assets held for sale at July 1, 2012. The North America segment and the Asia segment include $3.8 million and $6.2 million, respectively, in assets held for sale at July 3, 2011.

The Company sells its products into various end markets around the world and groups net sales to third parties into four product categories. Because many of the Company s sales are through distributors and third-party manufacturers representatives, a portion of the product categorization is based on management s understanding of final product use and, as such, allocations have been made to align sales into a product category. Net sales to third parties for the four product categories are as follows:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
	(in millions)			
Net Sales				
Residential & commercial flow control	**$ 211.3**	$ 199.2	**$ 412.5**	$ 365.6
HVAC & gas	**106.8**	122.1	**216.6**	235.6
Drains & water re-use	**35.0**	36.6	**68.7**	67.7
Water quality	**18.0**	17.8	**37.5**	36.7
Consolidated net sales	**$ 371.1**	$ 375.7	**$ 735.3**	$ 705.6

8. Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) consists of the following:

	Foreign Currency Translation	Pension Adjustment (in millions)	Accumulated Other Comprehensive Income (Loss)
Balance December 31, 2011	**$ 5.6**	**$ (24.6)**	**$ (19.0)**
Change in period	**16.5**	**0.2**	**16.7**
Balance April 1, 2012	**$ 22.1**	**$ (24.4)**	**$ (2.3)**
Change in period	**(39.7)**	**0.1**	**(39.6)**
Balance July 1, 2012	**$ (17.6)**	**$ (24.3)**	**$ (41.9)**
Balance December 31, 2010	$ 24.9	$ (25.2)	$ (0.3)
Change in period	34.0	0.8	34.8
Balance April 3, 2011	$ 58.9	$ (24.4)	$ 34.5
Change in period	14.7	0.8	15.5
Balance July 3, 2011	$ 73.6	$ (23.6)	$ 50.0

Table of Contents

Accumulated other comprehensive income (loss) in the consolidated balance sheets as of July 1, 2012 and July 3, 2011 consists primarily of cumulative translation adjustments and pension related net actuarial loss and prior service costs.

9. Debt

The Company s credit agreement (the Credit Agreement) provides for a multi-currency $300.0 million, five-year, senior unsecured revolving credit facility which may be increased by an additional $150.0 million under certain circumstances and subject to the terms of the Credit Agreement. The Credit Agreement has a sublimit of up to $75.0 million in letters of credit.

Borrowings outstanding under the Credit Agreement bear interest at a fluctuating rate per annum equal to (i) in the case of Eurocurrency rate loans, the British Bankers Association LIBOR rate plus an applicable percentage, ranging from 1.70% to 2.30%, determined by reference to the Company s consolidated leverage ratio plus, in the case of certain lenders, a mandatory cost calculated in accordance with the terms of the Credit Agreement, or (ii) in the case of base rate loans and swing line loans, the highest of (a) the federal funds rate plus 0.5%, (b) the rate of interest in effect for such day as announced by Bank of America, N.A. as its prime rate, and (c) the British Bankers Association LIBOR rate plus 1.0%, plus an applicable percentage, ranging from 0.70% to 1.30%, determined by reference to the Company s consolidated leverage ratio. In addition to paying interest under the Credit Agreement, the Company is also required to pay certain fees in connection with the credit facility, including, but not limited to, a facility fee and letter of credit fees. Under the Credit Agreement, the Company is required to satisfy and maintain specified financial ratios and other financial condition tests. The Credit Agreement matures on June 18, 2015. The Company may repay loans outstanding under the Credit Agreement from time to time without premium or penalty, other than customary breakage costs, if any, and subject to the terms of the Credit Agreement. As of July 1, 2012, the Company was in compliance with all covenants related to the Credit Agreement and had $265.4 million of unused and available credit under the Credit Agreement and $34.6 million of stand-by letters of credit outstanding on the Credit Agreement. The Company did not have any borrowings outstanding under the Credit Agreement at July 1, 2012.

The Company is a party to several note agreements as further detailed in Note 10 of Notes to Consolidated Financial Statements of the Annual Report on Form 10-K for the year ended December 31, 2011. These note agreements require the Company to maintain a fixed charge coverage ratio of consolidated EBITDA plus consolidated rent expense during the period to consolidated fixed charges. Consolidated fixed charges are the sum of consolidated interest expense for the period and consolidated rent expense. As of July 1, 2012, the Company was in compliance with all covenants regarding these note agreements. The note agreements include $75.0 million of unsecured senior notes maturing on May 15, 2013 which have been included in the current portion of long-term debt in the Company s balance sheet.

10. Contingencies and Environmental Remediation

As disclosed in Part I, Item 1, Product Liability, Environmental and Other Litigation Matters of the Company s Annual Report on Form 10-K for the year ended December 31, 2011, the Company was party to certain litigation. There have been no material developments with respect to the Company s contingencies and environmental remediation proceedings during the quarter ended July 1, 2012 except as noted below.

On March 8, 2012, Watts Water Technologies, Inc., Watts Regulator Co., and Watts Plumbing Technologies, Inc. were named as defendants in a putative nationwide class action complaint filed in the U.S. District Court for the Northern District of California seeking to recover damages and other relief based on the alleged failure of toilet connectors. The complaint seeks among other items, damages in an unspecified amount, replacement costs, injunctive relief, and attorneys fees and costs.

The Company is unable to estimate a range of reasonably possible loss for the above matter in which damages have not been specified because: (i) the proceedings are in the early stages; (ii) there is uncertainty as to the likelihood of a class being certified or the ultimate size of the class; (iii) there is uncertainty as to pending motions; (iv) there are significant factual issues to be resolved; and (v) there are novel legal issues presented. However, based on information currently known to the Company, it does not believe that these proceedings will have a material effect on its financial position, results of operations, cash flows or liquidity.

11. Employee Benefit Plans

The Company sponsors funded and unfunded non-contributing defined benefit pension plans that together cover substantially all of its U.S. employees. Benefits are based primarily on years of service and employees compensation. The funding policy of the Company for these plans is to contribute an annual amount that does not exceed the maximum amount that can be deducted for federal income tax purposes.

On October 31, 2011, the Company s Board of Directors voted to cease accruals of additional benefits effective December 31, 2011 under both the Company s Pension Plan and Supplemental Employees Retirement Plan. In 2011, the Company recorded a curtailment charge of approximately $1.5 million to write-off previously unrecognized prior service costs and reduced the projected benefit obligation by $12.5 million.

Table of Contents

The components of net periodic benefit cost are as follows:

	Second Quarter Ended		Six Months Ended	
	July 1, 2012	**July 3, 2011**	**July 1, 2012**	**July 3, 2011**
		(in millions)		
Service cost benefits earned and administrative costs	**$ 0.2**	$ 1.3	**$ 0.4**	$ 2.6
Interest costs on benefits obligation	**1.4**	1.5	**2.8**	3.0
Expected return on assets	**(1.7)**	(1.8)	**(3.5)**	(3.6)
Prior service costs and net actuarial loss amortization	**0.1**	0.8	**0.3**	1.6
Net periodic benefit cost	**$**	$ 1.8	**$**	$ 3.6

The information related to the Company s pension funds cash flow is as follows:

	Six Months Ended	
	July 1, 2012	**July 3, 2011**
	(in millions)	
Employer contributions	**$ 0.4**	$ 5.1

The Company expects to contribute approximately $0.3 million to its pension plans for the remainder of 2012.

12. Acquisitions

On April 29, 2011, the Company completed the acquisition of Socla and the related water controls business of certain other entities controlled by Danfoss A/S, in a share and asset purchase transaction. The final consideration paid was EUR 116.3 million. The purchase price was financed with cash on hand and euro-based borrowings under our Credit Agreement. The purchase price was equal to approximately $172.4 million based on the exchange rate of Euro to U.S. dollars as of April 29, 2011.

The Company accounted for the transaction as a business combination. The Company completed a purchase price allocation that resulted in the recognition of $79.7 million in goodwill and $39.9 million in intangible assets. Intangible assets consist primarily of customer relationships with estimated lives of 10 years and trade names with either 20-year lives or indefinite lives. The goodwill is attributable to the workforce of Socla and the synergies that are expected to arise as a result of the acquisition. The goodwill is not expected to be deductible for tax purposes. The following table summarizes the final value of the assets and liabilities acquired (in millions):

Cash	$ 7.4
Accounts receivable	28.2
Inventory	24.6

Fixed assets		46.8
Other assets		6.5
Intangible assets		39.9
Goodwill		79.7
Accounts payable		(8.2)
Accrued expenses and other		(19.4)
Deferred tax liability		(22.3)
Debt		(10.8)
Purchase price	$	172.4

The consolidated statement of operations for the second quarter and six months ended July 1, 2012 includes the results of Socla. The results include $34.4 million and $69.2 million of revenues and $3.2 million and $5.7 million of operating income, respectively, which includes restructuring charges of $0.1 million and $0.6 million, respectively.

Supplemental pro-forma information (unaudited)

Had the Company completed the acquisition of Socla at the beginning of 2011, net sales, net income from continuing operations and earnings per share would have been as follows:

Table of Contents

Amounts in millions (except per share information)	Second Quarter Ended July 3, 2011	Six Months Ended July 3, 2011
Net sales	$ 389.7	$ 753.0
Net income from continuing operations	$ 15.7	$ 29.0
Net income per share:		
Basic EPS continuing operations	$ 0.42	$ 0.77
Diluted EPS continuing operations	$ 0.41	$ 0.77

Net income from continuing operations for the second quarter and six months ended July 3, 2011 was adjusted to include $0.2 million and $0.7 million, respectively, of net interest expense related to the financing and $0.2 million and $0.9 million, respectively, of net amortization expense resulting from the estimated allocation of purchase price to amortizable tangible and intangible assets. Net income for the second quarter and six months ended July 3, 2011 was also adjusted to exclude $2.4 million and $3.5 million, respectively, of net acquisition-related charges and third-party costs.

On January 31, 2012, the Company completed the acquisition of tekmar Control Systems (tekmar) in a share purchase transaction. A designer and manufacturer of control systems used in heating, ventilation, and air conditioning application, tekmar is expected to enhance the Company s hydronic systems product offerings in the U.S. and Canada. The initial purchase price paid was CAD $18.0 million, with an earn-out based on future earnings levels being achieved. The total purchase price will not exceed CAD $26.2 million. Sales for tekmar in 2011 approximated CAD $11.0 million. The results of tekmar are included in the Company s North America segment since the acquisition date and are not material to the Company s consolidated financial statements. See Note 2 for additional information on purchase price allocations.

13. Subsequent Event

Dividend Declared

On July 31, 2012, the Company declared a quarterly dividend of eleven cents ($0.11) per share on each outstanding share of Class A Common Stock and Class B Common Stock payable on August 31, 2012 to stockholders of record at the close of business on August 20, 2012.

Table of Contents

Item 2. Management s Discussion And Analysis Of Financial Condition And Results Of Operations

Overview

The following discussion and analysis are provided to increase understanding of, and should be read in conjunction with, the accompanying unaudited consolidated financial statements and notes. In this quarterly report on Form 10-Q, references to the Company, Watts, we, us or ou refers to Watts Water Technologies, Inc. and its consolidated subsidiaries.

We operate on a 52-week fiscal year ending on December 31. Any quarterly or six-month data contained in this Quarterly Report on Form 10-Q generally reflects the results of operations for a 13-week or 26-week period, respectively.

We are a leading supplier of products for use in the water quality, water safety, water flow control and water conservation markets in both North America and EMEA (Europe, Middle East and Africa), with a growing presence in Asia. For over 137 years, we have designed and manufactured products that promote comfort and safety of people and the quality and conservation of water used in commercial and residential applications. We earn revenue and income almost exclusively from the sale of our products. Our principal product lines are:

- Residential & commercial flow control products includes products typically sold into plumbing and hot water applications such as backflow preventers, water pressure regulators, temperature and pressure relief valves, and thermostatic mixing valves.

- HVAC & gas products includes hydronic and electric heating systems for under-floor radiant applications, hydronic pump groups for boiler manufacturers and alternative energy control packages, and flexible stainless steel connectors for natural and liquid propane gas in commercial food service and residential applications. HVAC is an acronym for heating, ventilation and air conditioning.

- Drains & water re-use products includes drainage products and engineered rain water harvesting solutions for commercial, industrial, marine and residential applications.

- Water quality products includes point-of-use and point-of-entry water filtration, conditioning and scale prevention systems for both commercial and residential applications.

Our business is reported in three geographic segments: North America, EMEA and Asia. We distribute our products through three primary distribution channels: wholesale, do-it-yourself (DIY) and original equipment manufacturers (OEMs). Interest rates, the unemployment rate and credit availability have an indirect effect on the demand for our products due to the effect such rates have on the number of new residential and commercial construction starts and remodeling projects. All of these activities have an impact on our levels of sales and earnings. An additional factor that has had an effect on our sales and operating income is fluctuation in foreign currency exchange rates, as approximately 46% of our

sales and certain portions of our costs, assets and liabilities are denominated in currencies other than the U.S. dollar.

During the second quarter of 2012, sales decreased $4.6 million primarily from the depreciation of the euro against the dollar of $16.2 million offset by acquired sales of $13.1 million resulting from our acquisitions of Socla and tekmar. Organic sales decreased by 0.4% compared to last year s comparable period, with increased sales in our North American wholesale and DIY markets being offset by reduced sales in EMEA s OEM and wholesale markets. Organic sales in the second quarter of 2012 increased over the second quarter of 2011 in North America by $7.6 million, or 3.6%, increased in Asia by $0.2 million, or 3.4%, and decreased in EMEA by $9.3 million, or 5.9%. Organic sales growth excludes the impacts of acquisitions, divestitures and foreign exchange from year-over-year comparisons. We believe this provides investors with a more complete understanding of underlying sales trends by providing sales growth on a consistent basis. Organic net sales increases in North America were driven mainly by volume increases in certain markets, offset by lower volumes in EMEA. Gross margins increased in the second quarter of 2012 as compared to 2011 by 0.8 percentage points, driven principally by reduced acquisition-related costs. We continued with the conversion of our U.S. manufacturing facilities to lead-free production, which caused inefficiencies from pre-production costs and product outsourcing. However, the effect of this conversion on gross margins decreased during the second quarter of 2012 as compared to the first quarter of 2012. Our transition to lead-free products is in response to the federal *Reduction of Lead in Drinking Water Act,* which requires the weighted average lead content of the wetted surfaces of pipes, plumbing fittings and plumbing fixtures used in potable water applications to be reduced to no greater than 0.25% by January 2014. Commodity costs during the quarter were fairly stable. Operating income of $33.7 million increased by 26.7% in the second quarter of 2012 as compared to the second quarter of 2011, driven by lower restructuring costs, lower acquisition-related costs and contributions from acquisitions. Foreign exchange movements primarily related to a weakening of the euro against the U.S. dollar negatively affected operating earnings by $1.6 million, when compared to the same period of 2011.

Table of Contents

We believe that the factors relating to our future growth include the demand for clean water around the world, regulatory requirements relating to the quality and conservation of water, continued enforcement of plumbing and building codes, our ability to grow organically in select attractive market segments and geographic regions, the successful completion of selective acquisitions, both in our core markets as well as in new complementary markets, and a healthy economic environment, that fosters residential and commercial construction. Our acquisition strategy focuses on businesses that manufacture preferred brand name products that address our themes of water quality, water conservation, water safety, water flow control, HVAC and related complementary markets. We target businesses that will provide us with one or more of the following: an entry into new markets, an increase in shelf space with existing customers, a new or improved technology or an expansion of the breadth of our water quality, water conservation, water safety and water flow control and HVAC products for the residential and commercial construction markets.

We have completed 36 acquisitions since divesting our industrial and oil and gas business in 1999. On January 31, 2012, we completed the acquisition of tekmar Control Systems (tekmar) in a share purchase transaction. A designer and manufacturer of control systems used in heating, ventilation, and air conditioning applications, tekmar is expected to enhance our hydronic systems product offerings in the U.S. and Canada. The initial purchase price paid was CAD $18.0 million, with an earn-out based on the achievement of certain future earnings levels. The total purchase price will not exceed CAD $26.2 million. Sales for tekmar in 2011 were approximately CAD $11.0 million. On April 29, 2011, we completed the acquisition of Danfoss Socla S.A.S. (Socla) and the related water controls business of certain other entities controlled by Danfoss A/S, in a share and asset purchase transaction. The net purchase price of EUR 116.3 million was financed with cash on hand and euro-based borrowings under our Credit Agreement. The net purchase price was approximately $172.4 million based on the exchange rate of Euro to U.S. dollars as of April 29, 2011. Socla is a manufacturer of water protection valves and flow control solutions for the water market and the heating, ventilation and air conditioning market. Its major product lines include backflow preventers, check valves and pressure reducing valves. Socla is based in France, and its products are distributed worldwide for commercial, residential, municipal and industrial use. Socla s annual revenue for 2010 was approximately $130.0 million. Socla expands our residential and commercial plumbing and flow control product lines in EMEA and also adds to our HVAC product line.

Products representing a majority of our sales are subject to regulatory standards and code enforcement, which typically require that these products meet stringent performance criteria. Together with our commissioned manufacturers representatives, we have consistently advocated for the development and enforcement of such plumbing codes. We are focused on maintaining stringent quality control and testing procedures at each of our manufacturing facilities in order to manufacture products in compliance with code requirements and take advantage of the resulting demand for compliant products. We believe that the product development, product testing capability and investment in plant and equipment needed to manufacture products in compliance with code requirements, represent a competitive advantage for us.

Historically, we have faced a risk relating to our ability to respond to raw material cost fluctuations. We manage this risk by monitoring related market prices, working with our suppliers to achieve the maximum level of stability in their costs and related pricing, seeking alternative supply sources when necessary, purchasing forward commitments for raw materials, when available, implementing cost reduction programs and passing increases in costs to our customers in the form of price increases.

Another risk we face in all areas of our business is competition. We consider brand preference, engineering specifications, code requirements, price, technological expertise, delivery times, quality and breadth of product offerings to be the primary competitive factors. We believe that product development, product testing capability, breadth of product offerings and investment in plant and equipment needed to manufacture products in compliance with code requirements represent a competitive advantage for us. We are committed to maintaining our capital equipment at a level consistent with current technologies, and thus we expect to spend an aggregate of approximately $36.0 million during 2012 for purchases of capital equipment.

Recent Events

Stock Repurchase Program

We completed the previously announced stock repurchase program during the first week of July 2012. We purchased two million shares of our Class A Common stock for an aggregate cost of $65.8 million. During the quarter ended July 1, 2012, we repurchased approximately 1.9 million shares for approximately $63.2 million, at an average purchase price of approximately $32.88 per share.

Dividend Declared

On July 31, 2012, we declared a quarterly dividend of eleven cents ($0.11) per share on each outstanding share of Class A Common Stock and Class B Common Stock payable on August 31, 2012 to stockholders of record at the close of business on August 20, 2012.

Table of Contents

Results of Operations

Second Quarter Ended July 1, 2012 Compared to Second Quarter Ended July 3, 2011

Net Sales. Our business is reported in three geographic segments: North America, EMEA and Asia. Our net sales in each of these segments for each of the second quarters of 2012 and 2011 were as follows:

	Second Quarter Ended July 1, 2012		Second Quarter Ended July 3, 2011			% Change to Consolidated
	Net Sales	% Sales	Net Sales	% Sales	Change	Net Sales
			(dollars in millions)			
North America	**$ 221.8**	**59.8%**	$ 212.0	56.4%	$ 9.8	2.6%
EMEA	**142.8**	**38.5**	157.8	42.0	(15.0)	(4.0)
Asia	**6.5**	**1.7**	5.9	1.6	0.6	0.2
Total	**$ 371.1**	**100.0%**	$ 375.7	100.0%	$ (4.6)	(1.2)%

The change in net sales was attributable to the following:

					Change As a % of Consolidated Net Sales				Change As a % of Segment Net Sales		
	North America	EMEA	Asia	Total	North America	EMEA	Asia	Total	North America	EMEA	Asia
					(dollars in millions)						
Organic	$ 7.6	$ (9.3)	$ 0.2	$ (1.5)	2.0%	(2.5)%	0.1%	(0.4)%	3.6%	(5.9)%	3.4%
Foreign exchange	(0.9)	(15.5)	0.2	(16.2)	(0.2)	(4.1)		(4.3)	(0.4)	(9.8)	3.4
Acquired	3.1	9.8	0.2	13.1	0.8	2.6	0.1	3.5	1.4	6.2	3.4
Total	$ 9.8	$ (15.0)	$ 0.6	$ (4.6)	2.6%	(4.0)%	0.2%	(1.2)%	4.6%	(9.5)%	10.2%

Organic net sales in the North America wholesale market increased by $3.9 million, or 2.3%, in the second quarter of 2012, compared to the second quarter of 2011, mainly from increased sales in residential and commercial products of $2.6 million, or 2.1%, and HVAC and gas products of $0.7 million, or 3.4%. Organic sales increased in the North American DIY market by $3.7 million, or 8.9%, in the second quarter of 2012 compared to the second quarter of 2011, as residential and commercial products increased by $3.6 million, or 11.0%.

Organic net sales in the EMEA wholesale market decreased by $1.6 million, or 2.1%, in the second quarter of 2012 as compared to the same period in 2011. Sales gains from our drains product lines and our geographic expansion into the Middle East were offset by lower sales in Italy. Organic net sales into the OEM market were down approximately $6.4 million, or 8.6%, as compared to the second quarter of 2011. OEM demand was down due to destocking as a result of the weak heating season.

The net decrease in sales due to foreign exchange was primarily due to the depreciation of the euro against the U.S. dollar. We cannot predict whether the euro will appreciate or depreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our net sales.

Acquired net sales growth in North America was due to the inclusion of Socla and tekmar, and acquired net sales growth in EMEA and Asia was due to the inclusion of Socla.

Gross Profit. Gross profit and gross profit as a percent of net sales (gross margin) for the second quarters of 2012 and 2011 were as follows:

	Second Quarter Ended	
	July 1, 2012	**July 3, 2011**
	(dollars in millions)	
Gross profit	**$ 131.8**	$ 130.3
Gross margin	**35.5%**	34.7%

Gross margin increased 0.8 percentage points in the second quarter of 2012 compared to the second quarter of 2011 mainly as a result of reduced acquisition-related charges of $3.6 million incurred in 2011 for the Socla acquisition. North America s gross margin declined compared to second quarter of 2011 due to higher non-commodity costs, and pre-production and outsourcing costs caused by certain plants transitioning production to lead-free products. EMEA gross margin increased as a result of the 2011 Socla acquisition costs mentioned previously.

Table of Contents

Selling, General and Administrative Expenses. Selling, General and Administrative, or SG&A, expenses for the second quarter of 2012 decreased $1.3 million, or 1.3%, compared to the second quarter of 2011. The decrease in SG&A expenses was attributable to the following:

		(in millions)	% Change
Organic	$	(2.0)	(2.0)%
Foreign exchange		(3.8)	(3.9)
Acquired		4.5	4.6
Total	$	(1.3)	(1.3)%

The organic decrease in SG&A expenses was primarily due to lower personnel-related costs and lower depreciation and amortization of $2.6 million and $1.7 million, respectively. The lower personnel costs were driven primarily by selected headcount reductions and reduced net retirement costs resulting from our decision to freeze the defined benefit pension plan in the U.S. effective December 31, 2011. Depreciation and amortization charges were reduced primarily for impairment charges taken in 2011 for long-term assets of a European subsidiary. These cost decreases were offset by approximately $2.0 million of increased costs including higher insurance costs of $0.4 million primarily related to health insurance, increased IT costs of $0.3 million related primarily to an ERP implementation in Europe and hardware costs in North America, and sales related costs of $0.5 million driven by advertising expenses and other professional service costs. The decrease in SG&A expenses from foreign exchange was primarily due to the depreciation of the euro against the U.S. dollar in 2012. Acquired SG&A costs were related to the Socla and tekmar acquisitions. Total SG&A expenses, as a percentage of sales, were 26.1% in both the second quarter of 2012 and 2011, respectively.

Restructuring and Other Charges. In the second quarter of 2012, we recorded a charge of $1.2 million primarily for involuntary terminations and other costs incurred as part of our Europe and North America restructuring plans, as compared to $5.5 million of restructuring charges for the second quarter of 2011. For a more detailed description of our current restructuring plans, see Note 5 of Notes to Consolidated Financial Statements.

Operating Income. Operating income (loss) by geographic segment for the second quarters of 2012 and 2011 were as follows:

	Second Quarter Ended						% Change to Consolidated Operating Income
		July 1, 2012		July 3, 2011		Change	
	(dollars in millions)						
North America	**$**	**26.7**	$	26.3	$	0.4	1.5%
EMEA		**12.0**		6.9		5.1	19.2
Asia		**2.1**		0.9		1.2	4.5
Corporate		**(7.1)**		(7.5)		0.4	1.5
Total	**$**	**33.7**	$	26.6	$	7.1	26.7%

The increase (decrease) in operating income (loss) is attributable to the following:

						Change As a % of Consolidated Operating Income					**Change As a % of Segment Operating Income**			
	North America	**EMEA**	**Asia**	**Corp.**	**Total**	**North America**	**EMEA**	**Asia**	**Corp.**	**Total**	**North America**	**EMEA**	**Asia**	**Corp.**
	(dollars in millions)													
Organic	$ 1.2	$ 1.2	$ 0.9	$ 0.4	$ 3.7	4.5%	4.5%	3.4%	1.5%	13.9%	4.5%	17.4%	100.0%	(5.3)%
Foreign exchange	(0.2)	(1.5)	0.1		(1.6)	(0.8)	(5.6)	0.4		(6.0)	(0.7)	(21.7)	11.1	
Acquired	(0.1)	0.8			0.7	(0.4)	3.0			2.6	(0.4)	11.6		
Restructuring, impairment charges and other	(0.5)	4.6	0.2		4.3	(1.8)	17.3	0.7		16.2	(1.9)	66.6	22.2	
Total	$ 0.4	$ 5.1	$ 1.2	$ 0.4	$ 7.1	1.5%	19.2%	4.5%	1.5%	26.7%	1.5%	73.9%	133.3%	(5.3)%

The increase in consolidated organic operating income was due primarily to a net reduction in restructuring and other charges, a decrease in SG&A expense and an increase in gross margins, for reasons previously discussed. The increase in North America s organic operating income was driven by organic sales growth and lower SG&A costs. The EMEA organic operating income increase was due to lower acquisition-related costs in the second quarter of 2012 as compared to the same period last year and a decrease in SG&A costs, partially offset by lower profits from a reduction in organic sales. The acquired operating income was related to the Socla and tekmar acquisitions. Restructuring costs decreased primarily due to fewer charges related to restructuring programs in Europe.

Interest Expense. Interest expense decreased $0.6 million, or 9.0%, for the second quarter of 2012 as compared to the second quarter of 2011, primarily from a reduction in outstanding debt used in 2011 for the acquisition of Socla.

Table of Contents

Other, net. Other, net decreased $0.6 million for the second quarter of 2012 as compared to the second quarter of 2011, primarily due to a reduction in foreign currency transaction losses.

Income Taxes. Our effective rate for continuing operations decreased to 33.4% in the second quarter of 2012, from 33.8% for the second quarter of 2011. The decrease was mainly due to the mix of worldwide earnings, with more earnings being generated in 2012 in Europe and China, than in 2011.

Net Income. Net income for the second quarter of 2012 was $18.5 million, or $0.51 per common share, compared to $12.9 million, or $0.34 per common share, for the second quarter of 2011. Results for the second quarter of 2012 include an after-tax charge of $0.9 million, or $0.02 per common share, for restructuring and other charges related primarily to involuntary terminations and other costs compared to an after-tax restructuring and other charge of $3.7 million, or $0.10 per common share, for the second quarter of 2011. The depreciation of the euro and Canadian dollar against the U.S. dollar resulted in a negative impact on our operations of $0.03 per common share for the second quarter of 2012 when compared to the same period in 2011. Further, the effects of the share repurchase programs undertaken during the second quarter of 2012 and the third quarter of 2011 positively affected earnings per share by $0.02 when comparing second quarter results for 2012 and 2011.

Six Months Ended July 1, 2012 Compared to Six Months Ended July 3, 2011

Net Sales. Our business is reported in three geographic segments: North America, EMEA and Asia. Our net sales in each of these segments for each of the first six months of 2012 and 2011 were as follows:

	Six Months Ended July 1, 2012		Six Months Ended July 3, 2011			
	Net Sales	% Sales	Net Sales	% Sales	Change	% Change to Consolidated Net Sales
			(dollars in millions)			
North America	**$ 431.8**	**58.7%**	$ 414.1	58.7%	$ 17.7	2.5%
EMEA	**292.0**	**39.7**	281.8	39.9	10.2	1.4
Asia	**11.5**	**1.6**	9.7	1.4	1.8	0.3
Total	**$ 735.3**	**100.0%**	$ 705.6	100.0%	$ 29.7	4.2%

The change in net sales was attributable to the following:

					Change As a % of Consolidated Net Sales				Change As a % of Segment Net Sales		
	North America	EMEA	Asia	Total	North America	EMEA	Asia	Total	North America	EMEA	Asia
					(dollars in millions)						
Organic	$ 11.3	$ (10.4)	$ 0.7	$ 1.6	1.6%	(1.5)%	0.1%	0.2%	2.7%	(3.7)%	7.2%
Foreign exchange	(1.2)	(20.5)	0.4	(21.3)	(0.2)	(2.9)	0.1	(3.0)	(0.2)	(7.3)	4.2
Acquired	7.6	41.1	0.7	49.4	1.1	5.8	0.1	7.0	1.8	14.6	7.2
Total	$ 17.7	$ 10.2	$ 1.8	$ 29.7	2.5%	1.4%	0.3%	4.2%	4.3%	3.6%	18.6%

Organic net sales in the North America wholesale market increased by $5.5 million, or 1.7%, in the first six months of 2012, compared to the first six months of 2011, with increased sales of approximately $7.1 million in residential and commercial products being offset partially by a reduction in HVAC and gas products sales of approximately $3.1 million. Organic sales increased in the North America DIY market by $5.8 million, or 6.9%, in the first six months of 2012 compared to the first six months of 2011, as residential and commercial products and water quality products sales increased by $5.2 million and $0.7 million, respectively.

EMEA organic net sales in the wholesale market decreased by approximately $1.5 million, or 1.1%, in the first six months of 2012, as compared to the same period in 2011. Sales gains in France and from geographic expansion into the Middle East were offset by softer sales in Italy. Organic net sales into the OEM market were down approximately $7.0 million, or 5.3%, as compared to the first six months of 2011. Sales gains in hydronic under-floor heating packages and in our drains product lines were offset by reduced sales of certain pump controls and pre-insulated piping products due in part to weather related issues and due to lower sales activity, in general, in Italy.

The net decrease in sales due to foreign exchange was primarily due to the depreciation of the euro against the U.S. dollar. We cannot predict whether the euro will appreciate or depreciate against the U.S. dollar in future periods or whether future foreign exchange rate fluctuations will have a positive or negative impact on our net sales.

Acquired net sales growth in North America was due to the inclusion of Socla and tekmar, and acquired net sales growth in EMEA and Asia was due to the inclusion of Socla.

Gross Profit. Gross profit and gross profit as a percent of net sales (gross margin) for the first six months of 2012 and 2011 were as follows:

	Six Months Ended	
	July 1, 2012	**July 3, 2011**
	(dollars in millions)	
Gross profit	**$ 261.4**	$ 251.3
Gross margin	**35.6%**	35.6%

Table of Contents

Gross margins were consistent in the first six months of 2012 as compared to the first six months of 2011. North America s gross margin declined due to cost increases for non-commodity purchases as well as pre-production and outsourcing costs caused by certain plants transitioning production to lead-free products. That decline was offset by an increase in gross margins in EMEA related to acquisition related charges incurred in 2011 for the Socla acquisition that did not recur in 2012.

Selling, General and Administrative Expenses. Selling, General and Administrative, or SG&A, expenses for the first six months of 2012 increased $2.7 million, or 1.4%, compared to the first six months of 2011. The increase in SG&A expenses was attributable to the following:

		(in millions)	**% Change**
Organic	$	(6.9)	(3.5)%
Foreign exchange		(5.0)	(2.6)
Acquired		14.6	7.5
Total	$	2.7	1.4%

The organic decrease in SG&A expenses was primarily due to; (i) separation costs for our former Chief Executive Officer incurred in 2011 of $6.3 million; (ii) the impact of selected headcount reductions; (iii) reduced net retirement costs resulting from our decision to freeze the defined benefit pension plan in the U.S. effective December 31, 2011; and (iv) reduced depreciation and amortization in 2012 of $2.0 million related primarily to impairment charges taken in 2011 for certain long-lived assets of a European subsidiary, offset by approximately $2.6 million in higher insurance costs primarily related to product liability and health insurance. The decrease in SG&A expenses from foreign exchange was primarily due to the depreciation of the euro against the U.S. dollar in 2012. Acquired SG&A costs were related to the Socla and tekmar acquisitions. Total SG&A expenses, as a percentage of sales, were 26.9% in the first six months of 2012 compared to 27.7% in the first six months of 2011.

Restructuring and Other Charges. In the first six months of 2012, we recorded a charge of $2.9 million primarily for involuntary terminations and other costs incurred as part of our European and North American restructuring plans, as compared to $6.6 million of restructuring charges for the first six months of 2011. For a more detailed description of our current restructuring plans, see Note 5 of Notes to Consolidated Financial Statements.

Operating Income. Operating income (loss) by geographic segment for the first six months of 2012 and 2011 were as follows:

	Six Months Ended						
		July 1, 2012		**July 3, 2011**		**Change**	**% Change to Consolidated Operating Income**
				(dollars in millions)			
North America	**$**	**46.9**	$	53.0	$	(6.1)	(12.3)%
EMEA		**24.8**		16.6		8.2	16.6
Asia		**3.5**		1.7		1.8	3.6
Corporate		**(14.6)**		(21.8)		7.2	14.5
Total	**$**	**60.6**	$	49.5	$	11.1	22.4%

The increase (decrease) in operating income (loss) is attributable to the following:

	North America	EMEA	Asia	Corp.	Total	Change As a % of Consolidated Operating Income North America	EMEA	Asia	Corp.	Total	Change As a % of Segment Operating Income North America	EMEA	Asia	Corp.
						(dollars in millions)								
Organic	$ (5.3)	$ 2.3	$ 1.5	$ 7.2	$ 5.7	(10.7)%	4.6%	3.0%	14.5%	11.4	(10.0)%	13.9%	88.2%	(33.0)%
Foreign exchange	(0.2)	(1.9)	0.1		(2.0)	(0.4)	(3.8)	0.2		(4.0)	(0.4)	(11.5)	5.9	
Acquired	0.2	3.5			3.7	0.4	7.1			7.5	0.4	21.1		
Restructuring, impairment charges and other	(0.8)	4.3	0.2		3.7	(1.6)	8.7	0.4		7.5	(1.5)	25.9	11.8	
Total	$ (6.1)	$ 8.2	$ 1.8	$ 7.2	$ 11.1	(12.3)%	16.6%	3.6%	14.5%	22.4%	(11.5)%	49.4%	105.9%	(33.0)%

The increase in consolidated organic operating income in the first six months of 2012 was due in part to a net reduction in SG&A expenses at the Corporate level related to our former CEO s separation costs incurred in 2011 as previously discussed. The reduction in North America organic operating income was driven by lower gross margin and increased product liability costs. The increase in EMEA organic operating income was due to an improvement in gross margin primarily from lower acquisition related costs in the first six months of 2012 as compared to the same period last year. The acquired operating income related to Socla and tekmar. Additionally, restructuring costs increased primarily due to charges related to restructuring programs in Europe.

Interest Expense. Interest expense decreased $0.3 million, or 2.4%, for the first six months of 2012 as compared to the first six months of 2011, primarily due to the interest on additional borrowings in 2011 under our revolving line of credit incurred in connection with the acquisition of Socla.

Other, net. Other, net increased $1.6 million for the first six months of 2012 as compared to the first six months of 2011, primarily due to a reduction in foreign currency transaction losses and a customs settlement in Asia that was less than our reserve amount.

Income Taxes. Our effective tax rate for continuing operations decreased to 31.1% for the six months ended July 1, 2012 from 34.6% for the six months July 3, 2011. The higher rate in 2011 was largely due to non-deductible acquisition costs of $1.1 million associated with the Socla acquisition in Europe. Further, 2012 taxes were reduced by approximately $0.8 million for reserve releases, primarily related to the completion of a European subsidiary s tax audit.

Net Income. Net income for the first six months of 2012 was $34.2 million, or $0.93 per common share, compared to $24.0 million, or $0.64 per common share, for the first six months of 2011. Results for the first six months of 2012 include an after-tax charge of $1.9 million, or $0.06 per common share, for restructuring and other charges related primarily to involuntary terminations and other costs compared to an after-tax restructuring and other charge of $4.4 million, or $0.12 per common share, for the first six months of 2011. The depreciation of the euro and Canadian dollar against the U.S. dollar resulted in a negative impact on our operations of $0.04 per common share for the first six months of 2012 compared to the comparable period in 2011.

Liquidity and Capital Resources

We generated $23.9 million of cash from operating activities in the first six months of 2012 as compared to $20.7 million in the first six months of 2011. This increase is primarily due to better operating results. Cash from operating activities is typically lower in the first half due to normal seasonality in the business, and we anticipate cash flow improvement through the remainder of 2012.

We used $26.1 million of net cash for investing activities for the first six months of 2012, including $17.5 million for the acquisition of tekmar and $9.6 million of cash for capital equipment. For the remainder of fiscal year 2012, we expect to invest approximately $26 million in capital equipment as part of our ongoing commitment to improve our operating capabilities.

We used $79.8 million of net cash for financing activities for the first six months of 2012, primarily for our stock repurchase program, repayment of our line of credit and dividend payments, offset by proceeds from additional debt issuances and from employee share transactions.

Our credit agreement (the Credit Agreement) provides for a multi-currency $300.0 million, five-year, senior unsecured revolving credit facility which may be increased by an additional $150.0 million under certain circumstances and subject to the terms of the Credit Agreement. The Credit Agreement has a sublimit of up to $75.0 million in letters of credit.

Borrowings outstanding under the Credit Agreement bear interest at a fluctuating rate per annum equal to (i) in the case of Eurocurrency rate loans, the British Bankers Association LIBOR rate plus an applicable percentage, ranging from 1.70% to 2.30%, determined by reference to our consolidated leverage ratio plus, in the case of certain lenders, a mandatory cost calculated in accordance with the terms of the Credit Agreement, or (ii) in the case of base rate loans and swing line loans, the highest of (a) the federal funds rate plus 0.5%, (b) the rate of interest in effect for such day as announced by Bank of America, N.A. as its prime rate, and (c) the British Bankers Association LIBOR rate plus 1.0%, plus an applicable percentage, ranging from 0.70% to 1.30%, determined by reference to our consolidated leverage ratio. In addition to paying interest under the Credit Agreement, we are also required to pay certain fees in connection with the credit facility, including, but not limited to, a facility fee and letter of credit fees. Under the Credit Agreement, we are required to satisfy and maintain specified financial ratios and other financial condition tests. The Credit Agreement matures on June 18, 2015. We may repay loans outstanding under the Credit Agreement from time to time without premium or penalty, other than customary breakage costs, if any, and subject to the terms of the Credit Agreement. As of July 1, 2012, we had $34.6 million of stand-by letters of credit outstanding under the Credit Agreement. As of July 1, 2012, we were in compliance with all covenants related to the Credit Agreement and had $265.4 million of unused and available credit under the Credit Agreement.

Working capital (defined as current assets less current liabilities) as of July 1, 2012 was $400.5 million compared to $521.9 million as of December 31, 2011. Cash and cash equivalents decreased to $167.8 million as of July 1, 2012, compared to $250.6 million as of December 31, 2011. The ratio of current assets to current liabilities was 2.1 to 1 as of July 1, 2012 and 2.8 to 1 as of December 31, 2011. The decrease was driven primarily by our use of $63.2 million cash for our stock repurchase program and the increase in current portion of long-term debt related the inclusion of $75 million for our 5.47% senior notes due in May 2013.

As of July 1, 2012, we held $167.8 million in cash and cash equivalents. Our ability to fund operations from this balance could be limited by the liquidity in the market as well as possible tax implications of moving proceeds across jurisdictions. Of this amount, approximately $75.8 million of cash and cash equivalents were held by foreign subsidiaries. Our U.S. operations currently generate sufficient cash flows to meet our domestic obligations. We also have the ability to borrow funds at reasonable interest rates, utilize the committed funds under our Credit Agreement or recall intercompany loans. However, if amounts held by foreign subsidiaries were needed to fund operations in the United States, we could be required to accrue and pay taxes to repatriate these funds. Such charges may include a federal tax of up to 35.0% on dividends received in the U.S., potential state income taxes and an additional withholding

Table of Contents

tax payable to foreign jurisdictions of up to 10.0%. However, our intent is to permanently reinvest undistributed earnings of foreign subsidiaries and we do not have any current plans to repatriate them to fund operations in the United States.

We anticipate paying the $75.0 million of unsecured 5.47% senior notes maturing on May 15, 2013 through available funds or by successfully refinancing the debt.

Non-GAAP Financial Measures

We believe free cash flow to be an appropriate supplemental measure of our operating performance because it provides investors with a measure of our ability to generate cash, to repay debt, pay dividends, repurchase stock and to fund acquisitions. Other companies may define free cash flow differently. Free cash flow does not represent cash generated from operating activities in accordance with GAAP. Therefore it should not be considered an alternative to net cash provided by operations as an indication of our performance. Free cash flow should also not be considered an alternative to net cash provided by operations as defined by GAAP. The cash conversion rate of free cash flow to net income is also a measure of our performance in cash flow generation.

A reconciliation of net cash provided by operating activities to free cash flow and calculation of our cash conversion rate is provided below:

	Six Months Ended			
	July 1, 2012		**July 3, 2011**	
	(in millions)			
Net cash provided by operating activities	**$**	**23.9**	$	20.7
Less: additions to property, plant, and equipment		**(9.6)**		(12.0)
Plus: proceeds from the sale of property, plant, and equipment		**1.0**		0.6
Free cash flow	**$**	**15.3**	$	9.3
Net income from continuing operations	**$**	**34.2**	$	24.0
Cash conversion rate of free cash flow to net income from continuing operations		**44.7%**		38.8%

Our free cash flow improved in the first six months of 2012 when compared to the first six months of 2011 primarily due to higher operating profits and reduced capital expenditures.

Our net debt to capitalization ratio (a non-GAAP financial measure) for the first six months of 2012 was 20.0%, comparable to 13.9% at December 31, 2011. The increase in net debt to capitalization ratio is due primarily to cash outlay related to the stock repurchase program and the tekmar acquisition. Management believes the net debt to capitalization ratio is an appropriate supplemental measure because it helps investors understand our ability to meet our financing needs and as a basis to evaluate our financial structure. Our computation may not be comparable to other companies that may define their net debt to capitalization ratios differently.

A reconciliation of long-term debt (including current portion) to net debt and our net debt to capitalization ratio is provided below:

	July 1, 2012	December 31, 2011
	(in millions)	
Current portion of long-term debt	**$ 77.0**	$ 2.0
Plus: long-term debt, net of current portion	**308.1**	397.4
Less: cash and cash equivalents	**(167.8)**	(250.6)
Net debt	**$ 217.3**	$ 148.8

A reconciliation of capitalization is provided below:

	July 1, 2012	December 31, 2011
	(in millions)	
Net debt	**$ 217.3**	$ 148.8
Total stockholders equity	**869.1**	919.8
Capitalization	**$ 1,086.4**	$ 1,068.6
Net debt to capitalization ratio	**20.0%**	13.9%

We maintain letters of credit that guarantee our performance or payment to third parties in accordance with specified terms and conditions. Amounts outstanding were approximately $34.8 million as of July 1, 2012 and $34.9 million at December 31, 2011. Our letters of credit are primarily associated with insurance coverage and, to a lesser extent, foreign purchases and generally expire within

Table of Contents

one year of issuance. These instruments may exist or expire without being drawn down; therefore they do not necessarily represent future cash flow obligations.

Off-Balance Sheet Arrangements

Except for operating lease commitments, we have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

Application of Critical Accounting Policies and Key Estimates

The preparation of our consolidated financial statements in accordance with U.S. GAAP requires management to make judgments, assumptions and estimates that affect the amounts reported. A critical accounting estimate is an assumption about highly uncertain matters and could have a material effect on the consolidated financial statements if another, also reasonable, amount were used, or, a change in the estimate is reasonably likely from period to period. We base our assumptions on historical experience and on other estimates that we believe are reasonable under the circumstances. Actual results could differ significantly from these estimates. There were no changes in accounting policies or significant changes in accounting estimates during the first six months of 2012.

We periodically discuss the development, selection and disclosure of the estimates with our Audit Committee. Management believes the following critical accounting policies reflect its more significant estimates and assumptions.

Revenue recognition

We recognize revenue when all of the following criteria are met: (1) we have entered into a binding agreement, (2) the product has shipped and title has passed, (3) the sales price to the customer is fixed or is determinable and (4) collectability is reasonably assured. We recognize revenue based upon a determination that all criteria for revenue recognition have been met, which, based on the majority of our shipping terms, is considered to have occurred upon shipment of the finished product. Some shipping terms require the goods to be received by the customer before title passes. In those instances, revenues are not recognized until the customer has received the goods. We record estimated reductions to revenue for customer returns and allowances, cash discounts and for customer rebate programs. Provisions for returns and allowances and cash discounts are made at the time of sale, derived from historical trends and form a portion of the allowance for doubtful accounts. Customer rebate programs, which are primarily annual volume incentive plans, allow customers to earn credit for attaining agreed upon purchase targets from us. We record estimated reductions to revenue, made at the time of sale, for customer rebate programs based on estimated purchase targets.

Allowance for doubtful accounts

The allowance for doubtful accounts is established to represent our best estimate of the net realizable value of the outstanding accounts receivable. The development of our allowance for doubtful accounts varies by region but in general is based on a review of past due amounts, historical write-off experience, as well as aging trends affecting specific accounts and general operational factors affecting all accounts. In addition, factors are developed in certain regions utilizing historical trends of sales and returns and allowances and cash discount activities to derive a reserve for returns and allowances and cash discounts.

We uniformly consider current economic trends and changes in customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. We also aggressively monitor the creditworthiness of our largest customers, and periodically review customer credit limits to reduce risk. If circumstances relating to specific customers change or unanticipated changes occur in the general business environment, our estimates of the recoverability of receivables could be further adjusted.

Inventory valuation

Inventories are stated at the lower of cost or market with costs determined primarily on a first-in first-out basis. We utilize both specific product identification and historical product demand as the basis for determining our excess or obsolete inventory reserve. We identify all inventories that exceed a range of one to four years in sales. This is determined by comparing the current inventory balance against unit sales for the trailing twelve months. New products added to inventory within the past twelve months are excluded from this analysis. A portion of our products contain recoverable materials, therefore the excess and obsolete reserve is established net of any recoverable amounts. Changes in market conditions, lower-than-expected customer demand or changes in technology or features could result in additional obsolete inventory that is not saleable and could require additional inventory reserve provisions.

In certain countries, additional inventory reserves are maintained for potential shrinkage experienced in the manufacturing process. The reserve is established based on the prior year s inventory losses adjusted for any change in the gross inventory balance.

Goodwill and other intangibles

We have made numerous acquisitions over the years which included the recognition of a significant amount of goodwill. Goodwill is tested for impairment annually or more frequently if an event or circumstance indicates that an impairment loss may have been incurred. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of

Table of Contents

assets and liabilities to reporting units, and determination of the fair value of each reporting unit. We estimate the fair value of our reporting units using an income approach based on the present value of estimated future cash flows. We believe this approach yields the most appropriate evidence of fair value as our reporting units are not easily compared to other corporations involved in similar businesses. We have determined we have eight reporting units including Residential and Commercial, Dormont, Drains & Water re-use, BRAE, Water Quality, EMEA, Blücher, and Asia. Our Water Quality reporting unit does not have goodwill.

Intangible assets such as purchased technology are generally recorded in connection with a business acquisition. Values assigned to intangible assets are determined by an independent valuation firm based on our estimates and judgments regarding expectations of the success and life cycle of products and technology acquired.

Revised accounting guidance issued in September 2011 allows us to review goodwill for impairment utilizing either qualitative or quantitative analyses. We have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events and circumstances, we determine it is more likely than not that the fair value of a reporting unit is greater than its carrying amount, then performing the two-step (quantitative) impairment test is unnecessary.

We first identify those reporting units that we believe could pass a qualitative assessment to determine whether further impairment testing is necessary. For each reporting unit identified, our qualitative analysis includes:

1) A review of the most recent fair value calculation to identify the extent of the cushion between fair value and carrying amount, to determine if a substantial cushion existed.

2) A review of events and circumstances that have occurred since the most recent fair value calculation to determine if those events or circumstances would have affected our previous fair value assessment. Items identified and reviewed include macroeconomic conditions, industry and market changes, cost factor changes, events that affect the reporting unit, financial performance against expectations and the reporting unit s performance relative to peers.

We then compile this information and make our assessment of whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If we determine it is not more likely than not, then no further quantitative analysis is required.

The second analysis for goodwill impairment involves a quantitative two-step process. The first step of the impairment test requires a comparison of the fair value of each of our reporting units to the respective carrying value. If the carrying value of a reporting unit is less than its fair value, no indication of impairment exists and a second step is not performed. If the carrying amount of a reporting unit is higher than its fair value, there is an indication that impairment may exist and a second step must be performed. In the second step, the impairment is computed by comparing the implied fair value of the reporting unit s goodwill with the carrying amount of the goodwill. If the carrying amount of the reporting unit s goodwill is greater than the implied fair value of its goodwill, an impairment loss must be recognized for the excess and charged to operations.

Inherent in our development of the present value of future cash flow projections are assumptions and estimates derived from a review of our operating results, business plans, expected growth rates, cost of capital and tax rates. We also make certain assumptions about future economic conditions and other market data. We develop our assumptions based on our historical results including sales growth, operating profits, working capital levels and tax rates.

We believe that the discounted cash flow model is sensitive to the selected discount rate. We use third-party valuation specialists to help develop appropriate discount rates for each reporting unit. We use standard valuation practices to arrive at a weighted average cost of capital based on the market and guideline public companies. The higher the discount rate, the lower the discounted cash flows. While we believe that our estimates of future cash flows are reasonable, different assumptions could significantly affect our valuations and result in impairments in the future.

As of October 30, 2011, the annual impairment analysis date, the fair value of the EMEA reporting unit exceeded the carrying value by approximately 9%. Operating results for the EMEA reporting unit have been hindered by the downturn in the economic environment in Europe and continued to fall below expectations during the six months ended July 1, 2012, triggering the decision to update the impairment analysis. As a result of the updated fair value assessment, it was determined that the fair value of the EMEA reporting unit continues to exceed its carrying value, a result of a decrease in discount rate and a reduction of net debt offset by lower short-term projections. We also performed an analysis on the long-lived assets in the EMEA reporting unit as a result of the triggering event and concluded that these assets were not impaired.

Should the EMEA reporting units operating results decline further because the European marketplace deteriorates beyond our current expectations or should interest rates increase significantly, then the reporting unit s goodwill may be at risk for impairment in the future. The EMEA reporting unit s goodwill balance as of July 1, 2012 was $202.7 million.

Table of Contents

Product liability and workers compensation costs

Because of retention requirements associated with our insurance policies, we are generally self-insured for potential product liability claims and for workers compensation costs associated with workplace accidents. We are subject to a variety of potential liabilities in connection with product liability cases and we maintain excess product liability and other insurance coverage, which we believe to be generally in accordance with industry practices. For product liability cases in the U.S., management establishes its product liability accrual by utilizing third-party actuarial valuations that incorporate historical trend factors and our specific claims experience derived from loss reports provided by third-party administrators. In other countries, we maintain insurance coverage with relatively high deductible payments, as product liability claims tend to be smaller than those experienced in the U.S. Changes in the nature of claims or the actual settlement amounts could affect the adequacy of this estimate and require changes to the provisions, as we experienced in the first six months of 2012 when we incurred incremental costs of $2.1 million. Because the liability is an estimate, the ultimate liability may be more or less than reported.

Workers compensation liabilities in the U.S. are recognized for claims incurred (including claims incurred but not reported) and for changes in the status of individual case reserves. At the time a workers compensation claim is filed, a liability is estimated to settle the claim. The liability for workers compensation claims is determined based on management s estimates of the nature and severity of the claims and based on analysis provided by third-party administrators and by various state statutes and reserve requirements. We have developed our own trend factors based on our specific claims experience, discounted based on risk-free interest rates. We employ third-party actuarial valuations to help us estimate our workers compensation accrual. In other countries where workers compensation costs are applicable, we maintain insurance coverage with limited deductible payments. Because the liability is an estimate, the ultimate liability may be more or less than reported and is subject to changes in discount rates.

We maintain excess liability insurance with outside insurance carriers to minimize our risks related to catastrophic claims in excess of all self-insured positions. Any material change in the aforementioned factors could have an adverse impact on our operating results.

Legal contingencies

We are a defendant in numerous legal matters including those involving environmental law and product liability as discussed in more detail in Part I, Item 1, Business - Product Liability, Environmental and Other Litigation Matters, of our Annual Report on Form 10-K for the year ended December 31, 2011. As required by GAAP, we determine whether an estimated loss from a loss contingency should be accrued by assessing whether a loss is deemed probable and the loss amount can be reasonably estimated, net of any applicable insurance proceeds. Estimates of potential outcomes of these contingencies are developed in consultation with outside counsel. While this assessment is based upon all available information, litigation is inherently uncertain and the actual liability to fully resolve this litigation cannot be predicted with any assurance of accuracy. In the event of an unfavorable outcome in one or more legal matters, the ultimate liability may be in excess of amounts currently accrued, if any, and may be material to our operating results or cash flows for a particular quarterly or annual period. However, based on information currently known to us, management believes that the ultimate outcome of all legal contingencies, as they are resolved over time, is not likely to have a material effect on our financial position, results of operations, cash flows or liquidity.

Pension benefits

We account for our pension plans in accordance with GAAP, which involves recording a liability or asset based on the projected benefit obligation and the fair value of plan assets. Assumptions are made regarding the valuation of benefit obligations and the performance of plan assets. The primary assumptions are as follows:

- Weighted average discount rate this rate is used to estimate the current value of future benefits. This rate is adjusted based on movement in long-term interest rates.

- Expected long-term rate of return on assets this rate is used to estimate future growth in investments and investment earnings. The expected return is based upon a combination of historical market performance and anticipated future returns for a portfolio reflecting the mix of equity, debt and other investments indicative of our plan assets.

We determine these assumptions based on consultation with outside actuaries and investment advisors. Any variance in these assumptions could have a significant impact on future recognized pension costs, assets and liabilities.

On October 31, 2011, our Board of Directors voted to cease accruals of additional benefits effective December 31, 2011 under both the Pension Plan and Supplemental Employees Retirement Plan. Effective November 1, 2011, we began amortizing the unamortized gains and losses over the remaining life expectancy of the participants instead of our former policy of average remaining service period.

Income taxes

We estimate and use our expected annual effective income tax rates to accrue income taxes. Effective tax rates are determined based on budgeted earnings before taxes, including our best estimate of permanent items that will affect the effective rate for the year. Management periodically reviews these rates with outside tax advisors and changes are made if material variances from expectations are identified.

Table of Contents

We recognize deferred taxes for the expected future consequences of events that have been reflected in the consolidated financial statements. Deferred tax assets and liabilities are determined based on differences between the book values and tax bases of particular assets and liabilities, using tax rates in effect for the years in which the differences are expected to reverse. A valuation allowance is provided to offset any net deferred tax assets if, based upon the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. We consider estimated future taxable income and ongoing prudent tax planning strategies in assessing the need for a valuation allowance. We account for tax benefits when the item in question meets the more-likely-than-not (greater than 50% likelihood of being sustained upon examination by the taxing authorities) threshold.

New Accounting Standards

In December 2011, the FASB issued an amendment to the accounting guidance for disclosure of offsetting assets and liabilities and related arrangements. The amendment expands the disclosure requirements in that entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. The amendment is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013, and shall be applied retrospectively. We do not expect the adoption of this accounting pronouncement will have a material impact on our financial statements.

In July 2012, the FASB issued an amendment to the requirements for indefinite-lived intangible asset impairment testing. We have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If, after assessing the totality of events or circumstances, we determine it is more likely than not that the fair value of an indefinite-lived intangible asset is greater than its carrying amount, then performing the impairment test is unnecessary. We intend to adopt this new standard effective with our annual impairment testing date of October 30, for the year ending December 31, 2012.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We use derivative financial instruments primarily to reduce exposure to adverse fluctuations in foreign exchange rates, interest rates and costs of certain raw materials used in the manufacturing process. We do not enter into derivative financial instruments for trading purposes. As a matter of policy, all derivative positions are used to reduce risk by hedging underlying economic exposure. The derivatives we use are instruments with liquid markets.

Our consolidated earnings, which are reported in United States dollars, are subject to translation risks due to changes in foreign currency exchange rates. This risk is concentrated primarily in the exchange rate between the U.S. dollar and the euro; the U.S. dollar and the Canadian dollar; and the U.S. dollar and the Chinese yuan.

Our foreign subsidiaries transact most business, including certain intercompany transactions, in foreign currencies. Such transactions are principally purchases or sales of materials and are denominated in European currencies or the U.S. or Canadian dollar. We use foreign currency forward exchange contracts to manage the risk related to intercompany purchases that occur during the course of a year and certain open foreign currency denominated commitments to sell products to third parties. Realized and unrealized gains and losses on the contracts we recognized in

other (income) expense are not material.

We have historically had a low exposure on the cost of our debt to changes in interest rates. Information about our long-term debt, including principal amounts and related interest rates, appears in Notes 4 and 9 of this report and in Note 10 of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2011.

We purchase significant amounts of bronze ingot, brass rod, cast iron, steel and plastic, which are utilized in manufacturing our many product lines. Our operating results can be adversely affected by changes in commodity prices if we are unable to pass on related price increases to our customers. We manage this risk by monitoring related market prices, working with our suppliers to achieve the maximum level of stability in their costs and related pricing, seeking alternative supply sources when necessary, purchasing forward commitments for raw materials, when available, implementing cost reduction programs, value engineering, and passing increases in costs on to our customers in the form of price increases.

Item 4. Controls and Procedures

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended, or Exchange Act, as of the end of the period covered by this report, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively), of the effectiveness of our disclosure controls and procedures. In designing and evaluating our disclosure controls and procedures, we recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily applies its judgment in evaluating and implementing possible controls and procedures. The effectiveness of our disclosure controls and procedures is also necessarily limited by the staff and other resources available to us and the geographic diversity of our operations. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and

Table of Contents

procedures were effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act are accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting that occurred during the quarter ended July 1, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. In connection with these rules, we will continue to review and document our disclosure controls and procedures, including our internal control over financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our business.

Part II. OTHER INFORMATION

Item l. Legal Proceedings

As disclosed in Part I, Item 1, Product Liability, Environmental and Other Litigation Matters of our Annual Report on Form 10-K for the year ended December 31, 2011, we are party to certain litigation. There have been no material developments with respect to our contingencies and environmental remediation proceedings during the first six months ended July 1, 2012.

Item 1A. Risk Factors

This report may include statements that are not historical facts and are considered forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements reflect our current views about future results of operations and other forward-looking information. In some cases you can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, should and would or similar words. You should not rely on forward-looking statements because our actual may differ materially from those indicated by these forward-looking statements as a result of a number of important factors. These factors include, but are not limited to, the following: the current economic and financial condition, which can affect levels of housing starts and remodeling, affecting the markets where our products are sold, manufactured, or marketed; cost increases and technical challenges in connection with our conversion to lead-free compliant products; shortages in and pricing of raw materials and supplies; loss of market share through competition; introduction of competing products by other companies; pressure on prices from competitors, suppliers, and/or customers; changes in variable interest rates on our borrowings; identification and disclosure of material weaknesses in our internal control over financial reporting; failure to expand our markets through acquisitions; failure or delay in developing new products; lack of acceptance of new products; failure to manufacture products that meet required performance and safety standards; foreign exchange rate fluctuations; cyclicality of industries, such as plumbing and heating wholesalers and home improvement retailers, in which we market certain of our products; environmental compliance costs; product liability costs; the results and timing of our restructuring plans; changes in the status of current litigation, and other risks and uncertainties discussed in Part I, Item 1A, Item 1A. Risk Factors and in Note 14 of the Notes to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities Exchange Commission, and in other reports we file from time to time with the Securities and Exchange Commission.

32

Table of Contents

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

We satisfy the minimum withholding tax obligation due upon the vesting of shares of restricted stock and the conversion of restricted stock units into shares of Class A Common Stock by automatically withholding from the shares being issued a number of shares with an aggregate fair market value on the date of such vesting or conversion that would satisfy the withholding amount due.

The following table includes information with respect to shares of our Class A Common Stock withheld to satisfy withholding tax obligations during the three-month period ended July 1, 2012.

Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares (or Units) Purchased		(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
April 2, 2012 April 29, 2012					
April 30, 2012 May 27, 2012	5,493	$	36.36		
May 28, 2012 July 1, 2012					
Total	5,493	$	36.36		

The following table includes information with respect to the repurchases of our Class A Common Stock during the second quarter ended July 1, 2012 under our stock repurchase program.

April 2, 2012 April 29, 2012					
May 28, 2012 July 1, 2012	1,723,794	$	32.81	1,723,794	80,227

(1) On May 16, 2012, the Board of Directors authorized a stock repurchase program of up to two million shares of the Company s Class A Common Stock in open market purchases. During the quarter ended July 1, 2012, we repurchased approximately 1.9 million shares of Class A common stock at a cost of approximately $63.2 million. The remaining shares were purchased under the stock repurchase program in July 2012. The repurchase program has thus been completed.

Item 6. Exhibits

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q and such Exhibit Index is incorporated herein by reference.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WATTS WATER TECHNOLOGIES, INC.

Date:	August 9, 2012	By:	/s/ David J. Coghlan David J. Coghlan Chief Executive Officer (principal executive officer)
Date:	August 9, 2012	By:	/s/ William C. McCartney William C. McCartney Chief Financial Officer (principal financial officer)
Date:	August 9, 2012	By:	/s/ Timothy M. MacPhee Timothy M. MacPhee Treasurer and Chief Accounting Officer (principal accounting officer)

Table of Contents

EXHIBIT INDEX

Listed and indexed below are all Exhibits filed as part of this report.

Exhibit No.	Description
3.1	Restated Certificate of Incorporation, as amended (1)
3.2	Amended and Restated By-Laws (2)
10.1	Retention Agreement, dated as of June 14, 2012, between Watts Water Technologies, Inc. and William C. McCartney (3)
31.1	Certification of Principal Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
31.2	Certification of Principal Financial Officer pursuant Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. 1350
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. 1350
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

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* Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets at July 1, 2012 and December 31, 2011, (ii) Consolidated Statements of Operations for the Second Quarters Ended July 1, 2012 and July 3, 2011 and the Six Months Ended July 1, 2012 and July 3, 2011, (iii) Consolidated Statements of Comprehensive Income(Loss) for the Second Quarters Ended July 1, 2012 and July 3, 2011 and for the Six Months Ended July 1, 2012 and July 3, 2011, (vi) Consolidated Statements of Cash Flows for the Six Months Ended July 1, 2012 and July 3, 2011, and (vii) Notes to Consolidated Financial Statements.

In accordance with Rule 406T of Regulation S-T, the XBRL-related information in Exhibit 101 to this Quarterly Report on Form 10-Q is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act, is deemed not filed for purposes of section 18 of the Exchange Act, and otherwise is not subject to liability under these sections.

(1) Incorporated by reference to the Registrant s Quarterly Report on Form 10-Q (File No. 001-11499) for the quarter ended July 3, 2005.

(2) Incorporated by reference to the Registrant s Current Report on Form 8-K (File No. 001-11499) dated July 12, 2010.

(3) Incorporated by reference to the Registrant s Current Report on Form 8-K (File No. 001-11499) dated June 14, 2012.

372,976

$

38,240

$

19,546

$

27,270

$

—

$

—

$

458,032

Interest and other

—

—

—

—

—

27,690

27,690

Loss on disposition of assets, net

(179

)

—

—

—

—

(1,623

)

(1,802

)

372,797

38,240

19,546

27,270

—

26,067

483,920

Costs and expenses:

Oil and gas production

95,681

15,039

7,266

2,431

—

120,417

Depletion, depreciation and amortization

77,176

15,675

1,504

2,509

—

7,115

103,979

Impairment of long-lived assets

5,686

—

—

—

12,205

—

17,891

Exploration and abandonments

33,730

5,914

47

5,355

24,744

—

69,790

General and administrative

—

—

—

—

—

30,811

30,811

Accretion of discount on asset retirement obligations

—

—

—

—

—

2,146

2,146

Interest

—

—

—

—

—

30,502

30,502

Hurricane activity, net

47,000

—

—

—

—

—

47,000

Other

—

—

—

—

—

10,195

10,195

259,273

36,628

8,817

10,295

36,949

80,769

432,731

Income (loss) from continuing operations before income taxes

113,524

1,612

10,729

16,975

(36,949

)

(54,702

)

51,189

Income tax benefit (provision)

(42,004

)

(501

)

(3,111

)

(10,702

)

—

40,034

(16,284

)

Income (loss) from continuing operations

$

71,520

$

1,111

$

7,618

$

6,273

$

(36,949

)

$

(14,668

)

$

34,905

Three months ended June 30, 2006:

Revenues and other income:

Oil and gas

$

331,212

$

34,154

$

28,061

$

14,143

$

—

$

—

$

407,570

Interest and other

—

—

—

—

—

9,741

9,741

Gain (loss) on disposition of assets, net

150

77

—

—

—

(3,630

)

(3,403

)

331,362

34,231

28,061

14,143

—

6,111

413,908

Costs and expenses:

Oil and gas production

83,560

10,780

8,577

149

—

—

$

103,066

Depletion, depreciation and amortization

67,305

12,438

1,734

1,006

—

5,501

87,984

Exploration and abandonments

28,335

3,180

47

5,112

4,944

—

41,618

General and administrative

—

—

—

—

—

29,468

29,468

Accretion of discount on asset retirement obligations

—

—

—

—

—

1,154

1,154

Interest

—

—

—

—

—

22,766

22,766

Other

—

—

—

—

—

11,759

11,759

179,200

26,398

10,358

6,267

4,944

70,648

297,815

Income (loss) from continuing operations before income taxes

152,162

7,833

17,703

7,876

(4,944

)

(64,537

)

116,093

Income tax benefit (provision)

(55,539

)

(2,790

)

(5,311

)

(5,119

)

2,472

16,080

(50,207

)

Income (loss) from continuing operations

$

96,623

$

5,043

$

12,392

$

2,757

$

(2,472

)

$

(48,457

)

$

65,886

25

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

	United States (in thousands)	Canada	South Africa	Tunisia	Other	Headquarters	Consolidated Total
Six months ended June 30, 2007:							
Revenues and other income:							
Oil and gas	$ 691,446	$ 76,576	$ 32,734	$ 49,194	$ —	$ —	$ 849,950
Interest and other	—	—	—	—	—	41,606	41,606
Loss on disposition of assets, net	904	—	—	—	—	(2,446)	(1,542)
	692,350	76,576	32,734	49,194	—	39,160	890,014
Costs and expenses:							
Oil and gas production	179,194	30,004	11,312	4,320	—		224,830
Depletion, depreciation and amortization	146,560	28,832	2,575	4,064	—	14,086	196,117
Impairment of long-lived assets	5,686	—	—	—	12,205	—	17,891
Exploration and abandonments	97,382	10,516	91	8,184	29,989	—	146,162
General and administrative	—	—	—	—	—	65,255	65,255
Accretion of discount on asset retirement obligations	—	—	—	—	—	4,204	4,204
Interest	—	—	—	—	—	58,996	58,996
Hurricane activity, net	60,548	—	—	—	—	—	60,548
Other	—	—	—	—	—	18,608	18,608
	489,370	69,352	13,978	16,568	42,194	161,149	792,611
Income (loss) from continuing operations before income taxes	202,980	7,224	18,756	32,626	(42,194)	(121,989)	97,403
Income tax benefit (provision)	(75,103)	(2,243)	(5,439)	(20,349)	—	70,931	(32,203)
Income (loss) from continuing operations	$ 127,877	$ 4,981	$ 13,317	$ 12,277	$ (42,194)	$ (51,058)	$ 65,200
Six months ended June 30, 2006:							
Revenues and other income:							
Oil and gas	$ 641,093	$ 62,516	$ 55,857	$ 27,572	$ —	$ —	$ 787,038
Interest and other	—	—	—	—	—	22,852	22,852
Gain (loss) on disposition of assets, net	150	77	—	—	—	(3,703)	(3,476)
	641,243	62,593	55,857	27,572	—	19,149	806,414
Costs and expenses:							
Oil and gas production	161,461	21,694	13,679	915	—	—	197,749
Depletion, depreciation and amortization	130,921	19,668	6,284	2,151	—	11,366	170,390
Exploration and abandonments	64,616	6,596	130	6,254	46,664	—	124,260
General and administrative	—	—	—	—	—	61,715	61,715
Accretion of discount on asset retirement obligations	—	—	—	—	—	2,302	2,302
Interest	—	—	—	—	—	59,342	59,342
Hurricane activity, net	38,000	—	—	—	—	—	38,000

Other	—	—	—	—	—	16,813	16,813
	394,998	47,958	20,093	9,320	46,664	151,538	670,571
Income (loss) from continuing operations before income taxes	246,245	14,635	35,764	18,252	(46,664)	(132,389)	135,843
Income tax benefit (provision)	(89,879)	(5,213)	(10,729)	(11,334)	23,332	22,899	(70,924)
Income (loss) from continuing operations	$ 156,366	$ 9,422	$ 25,035	$ 6,918	$ (23,332)	$ (109,490)	$ 64,919

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

Segment Assets:	June 30, 2007 (in thousands)	December 31, 2006
United States	$ 7,061,938	$ 6,395,046
Argentina	2,336	2,444
Canada	578,884	547,012
South Africa	176,471	176,789
Tunisia	133,055	72,142
West Africa	17,576	41,238
Headquarters	167,603	120,728
Total consolidated assets	$ 8,137,863	$ 7,355,399

NOTE L. Volumetric Production Payments

During 2005, the Company sold 27.8 MMBOE of proved reserves by means of three VPP agreements for net proceeds of $892.6 million, including the assignment of the Company's obligations under certain derivative hedge agreements. Proceeds from the VPPs were initially used to reduce outstanding indebtedness. The first VPP sold 58 Bcf of gas volumes over an expected five-year term that began in February 2005. The second VPP sold 10.8 MMBbls of oil volumes over an expected seven-year term that began in January 2006. The third VPP sold 6.0 Bcf of gas volumes over an expected 32-month term that began in May 2005 and 6.2 MMBbls of oil volumes over an expected five-year term that began in January 2006.

The Company's VPPs represent limited-term overriding royalty interests in oil and gas reserves that: (i) entitle the purchaser to receive production volumes over a period of time from specific lease interests; (ii) do not bear future production costs and capital expenditures associated with the reserves; (iii) are nonrecourse to the Company (i.e., the purchaser's only recourse is to the assets acquired); (iv) transfer title of the reserves to the purchaser; and (v) allow the Company to retain the remaining reserves after the VPPs volumetric quantities have been delivered.

Under SFAS No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies," a VPP is considered a sale of proved reserves. As a result, the Company (i) removed the proved reserves associated with the VPPs; (ii) recognized the VPP proceeds as deferred revenue which are being amortized on a unit-of-production basis to oil and gas revenues over the terms of the VPPs; (iii) retained responsibility for 100 percent of the production costs and capital costs related to VPP interests; and (iv) no longer recognizes production associated with the VPP volumes.

The following table provides information about the deferred revenue carrying values of the Company's VPPs:

	Gas	Oil	Total
	(in thousands)		
Deferred revenue at December 31, 2006	$ 175,088	$ 489,423	$ 664,511
Less: 2007 amortization	(35,590)	(54,766)	(90,356)
Deferred revenue at June 30, 2007	$ 139,498	$ 434,657	$ 574,155

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

The above deferred revenue amounts will be recognized in oil and gas revenues in the Consolidated Statements of Operations as noted below, assuming the related VPP production volumes are delivered as scheduled (in thousands):

Remaining 2007	$	90,876
2008		158,139
2009		147,905
2010		90,215
2011		44,951
2012		42,069
	$	574,155

NOTE M. Interest and Other Income

The following table provides the components of the Company's interest and other income:

	Three months ended June 30,		**Six months ended June 30,**	
	2007	**2006**	**2007**	**2006**
	(in thousands)			
Alaskan Petroleum Production Tax credits (a)	$ 25,000	$ —	$ 25,000	$ —
Interest income	771	6,116	1,567	7,139
Royalty obligation credit	—	—	4,816	—
Business interruption insurance claim	—	—	—	3,647
Minority interest in subsidiary net loss (see Note B)	368	722	2,452	3,627
Canadian Alliance marketing gain	1,041	697	1,306	2,426
Bad debt recoveries	—	—	—	2,130
Sales and other tax refunds	—	25	3,704	25
Foreign currency remeasurement and exchange gains (b)	76	1,155	770	1,461
Other income	434	1,026	1,991	2,397
Total interest and other income	$ 27,690	$ 9,741	$ 41,606	$ 22,852

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(a) The Company earns Alaskan Petroleum Production Tax (“PPT”) credits on qualifying capital expenditures. During June 2007, the Company received a $25.0 million refund from the State of Alaska for a portion of its PPT credits. The Company does not record income from PPT credits until they are realized through a cash refund or sale.

(b) The Company's operations in Argentina, Canada and Africa periodically recognize monetary assets and liabilities in currencies other than their functional currencies. Associated therewith, the Company realizes foreign currency remeasurement and transaction gains and losses.

NOTE N. Insurance Claims

During August and September 2005, the Company sustained damages as a result of Hurricanes Katrina and Rita at various facilities in the Gulf of Mexico. Other than the East Cameron facility discussed further below, the damages to the facilities were covered by physical damage insurance.

The Company filed a business interruption claim with its insurance provider related to its Devils Tower field resulting from its inability to sell production as a result of damages to third-party facilities. During 2006, the Company settled its business interruption claim with its insurance provider for $18.5 million, of which none was recognized in the first half of 2006.

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

As a result of Hurricane Rita, the Company's East Cameron facility, located on the Gulf of Mexico shelf, was destroyed and the Company does not plan to rebuild the facility based on the economics of the field. In January 2007, the operations to reclaim and abandon the East Cameron facility began and the Company expects to incur a substantial portion of the reclamation and abandonment costs in 2007. The Company currently estimates that it will cost approximately $185 million to reclaim and abandon the East Cameron facility. The estimate to reclaim and abandon the East Cameron facility is based upon an analysis prepared by a third-party engineering firm for the majority of the work, an estimate by the Company for the remaining work that was not covered by the third-party analysis and actual abandonment activity to date. During 2007 and 2006, the Company recorded additional abandonment obligation charges of $66.0 million ($47.0 million recorded during the second quarter of 2007) and $75.0 million ($42.0 million recorded during the first six months of 2006), respectively.

The estimate to reclaim and abandon the East Cameron facility contains a number of assumptions that could cause the ultimate cost to be higher or lower as there are many uncertainties when working offshore and underwater with damaged equipment and well bores. The Company currently believes costs could range from $185 million to $217 million; however, at this point no better estimate than any other amount within the range can be determined, thus the Company has recorded the estimated provision of $185 million.

The Company has filed a claim with its insurance providers regarding the loss at East Cameron. Under the Company’s insurance policies, the East Cameron facility had the following coverages: (a) $14 million of scheduled property value for the platform, (b) $4 million of scheduled business interruption insurance after a deductible waiting period, (c) $100 million of well restoration and safety, in total, for all assets per occurrence and (d) $400 million for debris removal coverage for all assets per occurrence.

In December 2005, the Company received the $14 million of scheduled property value for the East Cameron assets and recognized a gain of $9.7 million associated therewith. The Company received the $4 million of business interruption recoveries in the first quarter of 2006, which is reflected in hurricane activity, net, in the Consolidated Statements of Operations. During the fourth quarter of 2006, the Company recorded estimated insurance recoveries of $43 million, which is reflected in other current assets in the accompanying Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006, related to the estimated costs for the known debris removal portion of the claim as the Company believes that it is probable that it will be successful in asserting coverage under the debris removal part of its insurance coverage. During the first half of 2007, the Company recognized $5.5 million of insurance recoveries for debris removal that were not related to the previously discussed recovery, which is reflected in hurricane activity, net, in the Consolidated Statement of Operations. No recoveries have been reflected related to the well restoration and safety coverages as the Company is working to resolve certain issues regarding coverage under this section of the insurance policies. The Company recently commenced legal actions against certain of its insurance carriers regarding policy coverage issues. The Company continues to expect that a substantial portion of the loss will be recoverable from insurance.

NOTE O. Impairment of Long-Lived Assets

Nigerian impairment. In June 2007, the Company entered into an agreement to divest its interest in a subsidiary (owned 59 percent by the Company) that held the interest in the deepwater Nigerian Block 320. The agreement was subject to governmental approval. The governmental approval was not obtained by the deadline and as a result, Pioneer terminated the agreement. Based on the terms of the agreement, which

established the Company's estimate of fair value, the Company recorded a $12.2 million impairment charge during the second quarter of 2007 to reduce the net basis to the estimated fair value.

Also, as a result of on-going due diligence efforts that emerged as part of the Company's compliance efforts, the Board of Directors of the Company with assistance from outside counsel determined that the Company cannot, consistent with its legal obligations, fund or approve future operations in connection with Block 320. In particular, the Board of Directors of the Company determined that based on recently obtained information, the Company could not continue its efforts with respect to Block 320 in a manner that is consistent with the U.S. Foreign Corrupt Practices Act. As a result, the Company is undertaking a process of withdrawal from the production sharing contract relating to Block 320 and related agreements. Although the Company believes that its actions are

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

compliant with its contractual obligations, other parties may dispute the Company's right to withdraw from (or its position that it is not obligated to perform under) the production sharing contract and related agreements and may bring legal actions against the Company to enjoin the actions or recover damages they allege have been caused thereby.

United States impairment. During the second quarter of 2007, the Company recorded a $5.7 million impairment provision to reduce the carrying values of certain proved oil and gas properties located in the Company's onshore Gulf Coast area. The impairment provision was determined in accordance with SFAS 144, and reduced the carrying values of the assets to their estimated fair value.

NOTE P. Discontinued Operations

During 2006, the Company sold its interests in the following oil and gas assets:

Country	**Description of Assets**	**Date Divested**	**Net Proceeds (in millions)**	**Gain**
United States	Deepwater Gulf of Mexico fields	March 2006	$ 1,156.9 (a)	$ 726.1
Argentina	Argentine assets	April 2006	$ 669.6	$ 10.9

____

(a) Net proceeds do not reflect the cash payment by the Company of $164.3 million for terminated hedges associated with the deepwater Gulf of Mexico assets.

Pursuant to SFAS 144, the Company has reflected the results of operations of the above divestitures as discontinued operations, rather than as a component of continuing operations. The following table represents the components of the Company's discontinued operations for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		**Six months ended June 30,**	
	2007	**2006**	**2007**	**2006**
	(in thousands)			

Revenues and other income:				
Oil and gas	$ 308	$ 18,108	$ 311	$ 199,677
Interest and other	1,534	19,411	3,787	21,258
Gain (loss) on disposition of assets (a)	(15)	4,282	(164)	732,784
	1,827	41,801	3,934	953,719
Costs and expenses:				
Oil and gas production	2	3,287	103	31,242
Depletion, depreciation and amortization (a)	—	—	—	37,327
Exploration and abandonments (a)	—	1,258	—	7,205
General and administrative	114	6,537	553	8,969
Accretion of discount on asset retirement obligations (a)	—	72	—	804
Interest	—	116	—	460
Other	10	222	37	1,712
	126	11,492	693	87,719
Income from discontinued operations before income taxes	1,701	30,309	3,241	866,000
Income tax benefit (provision):				
Current	(202)	(8,545)	(4,699)	(152,575)
Deferred (a)	76	389	2,331	(147,098)
Income from discontinued operations	$ 1,575	$ 22,153	$ 873	$ 566,327

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(a) Represents the significant noncash components of discontinued operations included in the Company's Consolidated Statements of Cash Flows.

PIONEER NATURAL RESOURCES COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2007

(Unaudited)

NOTE Q. Subsequent Event

In July 2007, Pioneer Southwest Energy Partners L.P. ("Pioneer Southwest"), a subsidiary of the Company, filed a preliminary registration statement with the SEC to sell limited partner interests, which is subject to completion. Pioneer Southwest will own interests in certain oil and gas properties, which are currently owned by the Company, in the Spraberry field in the Permian Basin of West Texas. Pioneer Southwest expects to sell 44.4 percent (before underwriters' over-allotment option) of its limited partner interests to the public.

PIONEER NATURAL RESOURCES COMPANY

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Financial and Operating Performance

The Company's financial and operating performance for the second quarter of 2007 included the following highlights:

- The recognition of second quarter 2007 net income of $36.5 million ($.30 per diluted share), as compared to $88.0 million ($0.69 per diluted share) for the second quarter of 2006. Net income for the second quarter of 2006 included income from discontinued operations of $22.2 million ($.17 per diluted share), principally reflecting a gain of $10.9 million on the divestiture of the Argentine assets in April 2006.
- A $25.0 million refund from the State of Alaska associated with Alaskan Petroleum Production Tax (“PPT”).
- A charge of $47.0 million related to incremental estimated costs to reclaim and abandon the East Cameron 322 facility and wells. The Company expects a substantial portion of this incremental cost to be recoverable from insurance.
- Charges totaling $35.4 million related to Nigerian activities ($12.2 million associated with impairment of Block 320 and $23.2 million associated with an unsuccessful well and acreage impairment on Block 256).
- Tax benefit in the U.S. of $40.0 million related to the Company’s plan to exit Nigeria.
- Net cash provided by operating activities was $217.4 million in the second quarter of 2007 as compared to $158.6 million in the comparable quarter of 2006. The increase in 2007, as compared to 2006, is primarily due to increased sales volumes along with increased NGL and gas prices realized from continuing operations.
- Repurchase of 469 thousand shares of common stock at an aggregate cost of $22.8 million under the Company’s share repurchase program.

Recent Events

Master Limited Partnership IPO. In July 2007, Pioneer Southwest Energy Partners L.P. (“Pioneer Southwest”), a subsidiary of the Company, filed a preliminary registration statement with the SEC to sell limited partner interests, which is subject to completion. Pioneer Southwest will own interests in certain oil and gas properties, which are currently owned by the Company, in the Spraberry field in the Permian Basin of West Texas. Pioneer Southwest expects to sell 44.4 percent (before underwriters’ over-allotment option) of its limited partner interests to the public.

This Report on Form 10-Q shall not constitute an offer to sell or the solicitation of an offer to buy any securities. Any offers, solicitations of offers to buy, or any sales of securities will only be made in accordance with the registration requirements of the Securities Act of 1933 or an exemption therefrom.

Share Repurchase Program. The Company announced in April 2007 that its Board approved a $450 million increase in its previously approved share repurchase program, which, after this increase, authorizes the purchase of up to $750 million of its common stock. Through June 30, 2007, the Company expended approximately $47.7 million of the amounts available under this program.

Amended Credit Agreement. In April 2007, the Company amended its credit facility and extended its maturity until April 2012. See Note E of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information regarding the terms of the amended credit facility and other long-term debt of the Company.

PIONEER NATURAL RESOURCES COMPANY

Capital Budget for 2007. In August 2007, the Company announced the expansion of its 2007 capital budget by $150 million to $1.45 billion, excluding acquisitions, effects of asset retirement obligations, capitalized interest and geological and geophysical administrative costs. The expansion is in response to (a) the continued drilling success in Tunisia, the Raton field in Colorado, the Bolton field in Mississippi, (b) drilling associated with the recent Fort Worth Barnett shale acquisition and planned Raton Basin acquisition and (c) the increase in facilities costs related to the Alaskan Oooguruk project. The 2007 capital budget is allocated (i) 46 percent to low-risk development drilling in onshore North American core areas, (ii) 22 percent to the development of the South African South Coast Gas and Alaskan Oooguruk projects, (iii) 28 percent to test and develop lower-risk resource plays in onshore North America and Tunisia and (iv) 4 percent to high-impact exploration activities in the United States and West Africa.

The Company believes that its cash flow from operating activities, based on current commodity prices, will not be sufficient to fund the 2007 capital budget. However, the Company believes that borrowings under its credit facility, proceeds from the IPO of Pioneer Southwest, cash flows from operating activities and proceeds from asset dispositions, if any, will be sufficient to fund the 2007 capital program.

Third Quarter 2007 Outlook

Based on current estimates, the Company expects that third quarter 2007 production will average 105,000 to 110,000 BOEPD. The lower end of the range primarily reflects the typical variability in the timing of oil cargo shipments in South Africa and Tunisia.

Third quarter production costs (including production and ad valorem taxes and transportation costs) are expected to average $11.50 to $12.50 per BOE based on current NYMEX strip prices for oil and gas. Depletion, depreciation and amortization ("DD&A") expense is expected to average $10.50 to $11.50 per BOE.

Total exploration and abandonment expense is expected to be $30 million to $60 million and could include up to $32 million from activities in the Company’s resource plays, primarily in the Edwards Trend in South Texas, Unita/Piceance in the Rockies area and Tunisia and $28 million in seismic investments, personnel costs and acreage and other costs.

General and administrative expense is expected to be $30 million to $34 million. Interest expense is expected to be $34 million to $37 million as a result of increased borrowings during the first half of 2007 to fund the front-end loaded 2007 capital program and a reduction in capitalized interest associated with the start-up of the South Coast Gas project. Accretion of discount on asset retirement obligations is expected to be $2 million to $3 million.

The Company's third quarter 2007 effective income tax rate is expected to range from 40 percent to 45 percent based on current capital spending plans.

Acquisitions, Divestments, Operations and Drilling Highlights

During the first half of 2007, the Company spent over $907.6 million of its $1.45 billion capital budget. The 2007 capital budget was front-end loaded with expenditures to progress the Company’s large development projects (the South Coast Gas project in South Africa and the Oooguruk field development on the North Slope of Alaska), drill high-impact exploration projects in Alaska and Nigeria and to drill winter-access areas in Canada.

During March 2006, the Company sold its interests in certain oil and gas properties in the deepwater Gulf of Mexico for net proceeds of $1.2 billion, resulting in a gain of $726.1 million. During April 2006, the Company sold its Argentine assets for net proceeds of $669.6 million, resulting in a gain of $10.9 million. The historic results of these properties and the related gains on disposition are reported as discontinued operations.

PIONEER NATURAL RESOURCES COMPANY

The following table summarizes by geographic area the Company's finding and development costs incurred during the first half of 2007:

	Acquisition Costs		Exploration	Development	Asset Retirement	
	Proved	Unproved	Costs	Costs	Obligations	Total
United States:						
Permian Basin	$ 3,000	$ 15,429	$ 17,116	$ 187,105	$ 122	$ 222,772
Mid-Continent	245	—	5	6,344	—	6,594
Rocky Mountains	561	910	29,823	103,911	381	135,586
Gulf of Mexico	—	13	1,657	549	2,340	4,559
Onshore Gulf Coast	4,726	4,977	64,402	70,341	153	144,599
Fort Worth Barnett Shale	5,598	34,381	1,875	—	21	41,875
Alaska	—	1,555	31,686	162,087	—	195,328
	14,130	57,265	146,564	530,337	3,017	751,313
Canada	82	3,620	26,359	57,081	1,057	88,199
South Africa	—	—	91	101,749	—	101,840
Tunisia	40	1,000	57,886	4,032	992	63,950
Other Foreign	—	—	4,317	—	—	4,317
West Africa:						
Equatorial Guinea	—	—	541	—	—	541
Nigeria	—	—	18,289	—	—	18,289
	122	4,620	107,483	162,862	2,049	277,136
Total Worldwide	$ 14,252	$ 61,885	$ 254,047	$ 693,199	$ 5,066	$ 1,028,449

The following table summarizes the Company's development and exploration/extension drilling activities for the six months ended June 30, 2007:

	Development Drilling				
	Beginning Wells in Progress	Wells Spud	Successful Wells	Unsuccessful Wells	Ending Wells In Progress
United States	18	301	295	—	24
Canada	3	—	1	1	1
South Africa	2	1	3	—	—
Total Worldwide	23	302	299	1	25

	Exploration/Extension Drilling				
	Beginning Wells in Progress	Wells Spud	Successful Wells	Unsuccessful Wells	Ending Wells In Progress
United States	21	22	13	3	27
Canada	16	17	7	6	20
Tunisia	5	5	3	1	6
West Africa – Nigeria	—	1	—	1	—
Total Worldwide	42	45	23	11	53

PIONEER NATURAL RESOURCES COMPANY

Permian Basin area. The Company expects to drill approximately 360 wells in 2007 compared to the 300 wells drilled in 2006. The increase is due to the attractive returns on the Spraberry wells and the success of drilling to the deeper Wolfcamp formations in the majority of the newly drilled wells in the Spraberry field, resulting in incremental production and proved reserves. The Company is continuing to pursue acreage expansion opportunities and bolt-on acquisitions in the area.

In July 2007, the Company entered into an agreement under which the Company has the option to purchase an additional 22 percent interest in the Spraberry Midkiff-Benedum gas processing system for $230 million, subject to normal closing adjustments. The additional 22% can be purchased in increments in 2008 and 2009 and, if exercised, will increase the Company’s interest in the system to 49 percent. In conjunction with this transaction, the Company extended its percent of proceeds (“POP”) contract with the plant ten years to 2022 and allowed for incremental increases in the Company’s POP beginning in 2009.

Mid-Continent area. The Company continues to pursue field enhancement alternatives to optimize production in the area. In the Hugoton field, the Company has received regulatory approval and plans to commence commingling of production from the Panoma and Council Grove formations. Pioneer is pursuing regulatory relief in the West Panhandle field to allow for additional future drilling locations.

Rocky Mountains area. Pioneer expects to drill approximately 250 to 300 wells in the Raton field during 2007. Production is increasing as a result of a successful drilling program plus additional field and wellhead compression. Additionally, the Company intends to further enhance its gathering and compression facilities in the area during 2007.

In July 2007, the Company entered into an agreement to acquire an interest in approximately 30,000 net acres in the Raton Basin for $205 million, subject to normal closing adjustments. The acquired interest has approximately 95 Bcf of proved reserves and has current production of approximately 10 MMcfpd. The acquisition is expected to close in the fourth quarter of 2007.

In northwest Colorado, the Company's programs to evaluate the CBM resource potential at Lay Creek and Columbine Springs are progressing. If the pilot projects are successful in producing commercial quantities of gas, full field development could begin in 2008.

Gulf of Mexico area. During March 2006, the Company sold its interests in certain oil and gas properties in the deepwater Gulf of Mexico for net proceeds of $1.2 billion, resulting in a gain of $726.1 million.

During 2006, the Company drilled two successful Clipper appraisal wells. The Company expects to develop the Clipper discovery and is currently evaluating subsea tie-back options to third-party production handling facilities in the area. Pioneer operates the Clipper discovery with a 55 percent working interest.

As a result of Hurricane Rita, the Company's East Cameron facility, located on the Gulf of Mexico shelf, was destroyed and the Company does not plan to rebuild the facility based on the economics of the field. In January 2007, the operations to reclaim and abandon the East Cameron facility began and the Company expects to incur a substantial portion of the reclamation and abandonment costs in 2007. During the second quarter of 2007, the Company increased the estimated cost to reclaim and abandon the East Cameron facility by $47.0 million to an aggregate estimated cost of $185 million. The estimate to reclaim and abandon the East Cameron facility is based upon an analysis prepared by a third-party engineering firm for the majority of the work, an estimate by the Company for the remaining work that was not covered by the third-party analysis and actual abandonment activity to date. The Company recently commenced legal actions against certain of its insurance carriers regarding policy coverage issues. The Company continues to expect that a substantial portion of the loss will be recoverable from insurance.

Onshore Gulf Coast area. The Company expects to drill approximately 45 wells (including wells on two to three new prospects) in the Edwards Trend during 2007. The Company continues to add the necessary infrastructure, primarily gas treating capacity and pipeline systems, related to its discoveries and development activity in the trend.

PIONEER NATURAL RESOURCES COMPANY

In the Edwards Trend, the Company also continues its shooting and interpretation of approximately 900 square miles of 3-D seismic data over its 2006 discoveries. The seismic data will allow the Company to more accurately locate and orient the horizontal wells for optimal results.

In the Pawnee field in South Texas, the Company is continuing its new fracture stimulation procedures on the existing wells. The results to date have shown increased production rates and the Company believes the procedure is increasing the recoverable reserves from the wells.

In Mississippi, the Company drilled two successful Cotton Valley wells in the Bolton field and installed a gas treating facility, with a current capacity of 10 MMcfpd, to process the gas. Production from the field is currently limited to the gas treating facility capacity. The Company is planning a 3-D seismic shoot in 2008 for the Bolton field to better define the resource potential and 2008 drilling plans.

Fort Worth Barnett Shale. During the second quarter of 2007, the Company acquired approximately 13,000 gross acres in the Fort Worth Barnett Shale play. The Company has commenced seismic activities and expects to drill up to 10 wells in 2007 on its acreage. The Company plans to pursue additional acquisitions in the area.

Alaska area. On the Oooguruk project, the subsea flowline and facilities to carry produced liquids to existing onshore processing facilities at the Kuparuk River Unit have been installed. Pioneer is currently assembling the drilling rig on location and plans to commence drilling approximately 40 horizontal wells to develop the discovery in the second half of 2007. The Company estimates first production will occur during the first half of 2008.

The Company has a 100 percent working interest in the Cosmopolitan Unit. The Company expects to drill an appraisal well to test an additional zone in the previous Cosmopolitan discovery during the second half of 2007.

During the 2006-2007 winter drilling season, the Company participated in drilling two exploratory wells in the National Petroleum Reserve - Alaska area, both of which were noncommercial.

Canada. During the second quarter of 2007, the Company announced that a new gas field discovered in northern Alberta had begun producing at 18 MMcfpd. Subsequently, the field was shut-in due to the need for increased water handling capabilities, which the Company plans to address during the 2008 winter drilling season.

South Africa. First production from the Company’s South Coast Gas project is expected late in the third quarter of 2007.

Tunisia. As a result of recent drilling success, the Company is increasing its 2007 capital budget. The Company is currently planning to drill at least 6 additional wells in 2007.

In the Adam Concession, the Company has a new discovery and two successful appraisal wells. All three of the wells are currently on production and the Company plans to drill two additional wells in the second half of 2007.

On the Jenein Nord exploration permit, the Company has drilled five discoveries and plans to drill three additional exploration wells during the second half of 2007. The Company is constructing the production facilities and is in the process of applying for a production concession. Production is expected to commence in the fourth quarter of 2007.

The Company's Anaguid exploration permit is located immediately north of the Jenein Nord exploration permit. The Company has acquired an additional 15 percent interest in the Anaguid permit, subject to certain conditions, including governmental approval. The acquisition will increase the Company's Anaguid interest to 60 percent and result in the transfer of operations to Pioneer. The Company expects that in connection with the governmental approval, the permit will be extended for eighteen months and the Company will commit to drill a well during the extension period. Following governmental approval of the acquisition, the Company intends to acquire additional 3-D seismic data over portions of the Anaguid and Jenein Nord permits, and expects to drill an Anaguid exploration well in 2008.

During 2007, the Company also had a discovery on the Borj El Khadra exploration permit. The Company expects to drill an appraisal well in the second half of 2007.

Nigeria. During the second quarter of 2007, the Company participated in the drilling of the Ofuruma 1X well on the Devon Energy-operated Block 256 in deepwater Nigeria. The Ofuruma 1X well found only non-commercial oil and gas accumulations and fulfills the Company's drilling commitments on Block 256. The Company is in the process of relinquishing its interest in Block 256.

A subsidiary of the Company joined other companies in a production sharing contract covering the oil prospecting license for Block 320 in deepwater Nigeria, gaining exploration rights from the Nigerian National Petroleum Corporation. The subsidiary, which holds a 51 percent interest in Block 320, is indirectly owned 59 percent by the Company and 41 percent by an unaffiliated third party. In July 2007, the Company announced that it had reached an agreement to divest its interest with respect to Block 320, subject to governmental approvals and certain other conditions. The purchaser was unable to obtain the requisite governmental approvals prior to the deadline set forth in the agreement (as extended) and as a result, the Company terminated the agreement.

As a result of on-going due diligence efforts that emerged as part of the Company's compliance efforts, the Board of Directors of the Company with assistance from outside counsel determined that the Company cannot, consistent with its legal obligations, fund or approve future operations in connection with Block 320. In particular, the Board of Directors of the Company determined that based on recently obtained information, the Company could not continue its efforts with respect to Block 320 in a manner that is consistent with the U.S. Foreign Corrupt Practices Act. As a result, the Company is undertaking a process of withdrawal from the production sharing contract relating to Block 320 and related agreements. Although the Company believes that its actions are compliant with its contractual obligations, other parties may dispute the Company's right to withdraw from (or its position that it is not obligated to perform under) the production sharing contract and related agreements and may bring legal actions against the Company to enjoin the actions or recover damages they allege have been caused thereby.

Equatorial Guinea. The Company owns a 50 percent interest in Block H in deepwater Equatorial Guinea, which covers over 240,000 acres. In late 2006, the Republic of Equatorial Guinea ratified a new hydrocarbons law, which effectively increases the obligations of the parties subject to the underlying production sharing contract in various respects. In addition, drilling costs have increased significantly beyond those originally anticipated. The Company and the other parties in Block H have been evaluating the effect of the new hydrocarbons law and the increased well costs, but have been unable to reach an agreement as to the parties' obligations. As a result, the parties have commenced arbitration to determine the parties' relative rights under a joint operating agreement relating to well operations in Block H. See Note I of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for specific information regarding the Company's arbitration associated with Block H.

Results of Operations

Oil and gas revenues. Oil and gas revenues from continuing operations totaled $458.0 million and $850.0 million for the three and six months ended June 30, 2007, respectively, as compared to $407.6 million and $787.0 million for the same respective periods of 2006.

The increase in oil and gas revenues from continuing operations during the three and six months ended June 30, 2007, as compared to the same periods of 2006, is reflective of increases in United States, Canadian and Tunisian revenues, partially offset by a decline in South African revenues. The increase in revenues in the United States was primarily due to volume increases resulting from successful drilling activity and reductions in scheduled volumetric production payment ("VPP") deliveries, combined with an increase in reported natural gas liquids ("NGL") and gas prices. Revenues in Canada and Tunisia increased primarily due to new volumes attributable to successful drilling programs, partially offset by decreases in commodity prices. South African revenues declined due to normal production decline rates in the Sable field and the timing of oil cargo liftings combined with a decline in reported oil prices.

PIONEER NATURAL RESOURCES COMPANY

The following table provides average daily sales volumes from continuing operations, by geographic area and in total, for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Six months ended June 30,	
	2007	**2006**	**2007**	**2006**
Oil (Bbls):				
United States	18,753	17,671	18,779	17,320
Canada	292	307	326	292
South Africa	3,080	4,284	2,716	4,680
Tunisia	3,763	2,309	3,927	2,441
Worldwide	25,888	24,571	25,748	24,733
NGLs (Bbls):				
United States	17,685	18,731	17,272	18,455
Canada	455	412	397	415
Worldwide	18,140	19,143	17,669	18,870
Gas (Mcf):				
United States	308,342	286,270	295,540	280,553
Canada	54,176	44,801	50,962	40,317
Tunisia	7,250	—	3,645	—
Worldwide	369,768	331,071	350,147	320,870
Total (BOE):				
United States	87,828	84,114	85,307	82,533
Canada	9,777	8,186	9,217	7,427
South Africa	3,080	4,284	2,716	4,680
Tunisia	4,971	2,309	4,535	2,441
Worldwide	105,656	98,893	101,775	97,081

On a quarter-to-quarter BOE comparison, average daily sales volumes increased by 4 percent in the United States, 19 percent in Canada and 115 percent in Tunisia, while average daily sales volumes decreased by 28 percent in South Africa. In Tunisia, the Company recorded gas sales volumes and revenue under a gas sales arrangement that was completed during the second quarter of 2007.

During the three and six month periods ended June 30, 2007, as compared to the three and six month periods ended June 30, 2006, oil and gas volumes delivered under the Company’s VPPs decreased by five percent (825 BOE per day) and five percent (736 BOE per day), respectively.

PIONEER NATURAL RESOURCES COMPANY

The oil, NGL and gas prices that the Company reports are based on the market price received for the commodities adjusted by the results of the Company's cash flow hedging activities and the amortization of deferred VPP revenue. The following table provides average reported prices from continuing operations (including the results of hedging activities and the amortization of deferred VPP revenue) and average realized prices from continuing operations (excluding the results of hedging activities and the amortization of deferred VPP revenue) by geographic area and in total, for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		**Six months ended June 30,**	
	2007	**2006**	**2007**	**2006**
Average reported prices:				
Oil (per Bbl):				
United States	$ 57.93	$ 69.43	$ 54.97	$ 64.82
Canada	$ 60.79	$ 72.37	$ 51.94	$ 69.89
South Africa	$ 69.73	$ 71.98	$ 66.59	$ 65.94
Tunisia	$ 64.89	$ 67.30	$ 62.11	$ 62.41
Worldwide	$ 60.38	$ 69.71	$ 57.25	$ 64.86
NGL (per Bbl):				
United States	$ 39.11	$ 35.84	$ 35.51	$ 34.81
Canada	$ 55.17	$ 57.97	$ 56.87	$ 56.10
Worldwide	$ 39.52	$ 36.32	$ 35.99	$ 35.28
Gas (per Mcf):				
United States	$ 7.53	$ 6.08	$ 7.36	$ 6.33
Canada	$ 6.96	$ 7.35	$ 7.53	$ 7.48
Tunisia	$ 7.65	$ —	$ 7.65	$ —
Worldwide	$ 7.45	$ 6.25	$ 7.39	$ 6.48
Average realized prices:				
Oil (per Bbl):				
United States	$ 60.82	$ 66.06	$ 58.13	$ 63.15
Canada	$ 60.79	$ 72.37	$ 51.94	$ 69.89
South Africa	$ 69.73	$ 71.26	$ 66.59	$ 65.61
Tunisia	$ 64.89	$ 67.30	$ 62.11	$ 62.41
Worldwide	$ 62.48	$ 67.15	$ 59.55	$ 63.63
NGL (per Bbl):				
United States	$ 39.11	$ 35.84	$ 35.51	$ 34.81
Canada	$ 55.17	$ 57.97	$ 56.87	$ 56.10
Worldwide	$ 39.52	$ 36.32	$ 35.99	$ 35.28
Gas (per Mcf):				
United States	$ 6.49	$ 5.56	$ 6.37	$ 6.26
Canada	$ 6.32	$ 6.90	$ 6.43	$ 7.14
Tunisia	$ 7.65	$ —	$ 7.65	$ —
Worldwide	$ 6.49	$ 5.75	$ 6.39	$ 6.37

Hedging activities. The Company, from time to time, utilizes commodity swap and collar contracts in order to (i) reduce the effect of price volatility on the commodities the Company produces and sells, (ii) support the Company's annual capital budgeting and expenditure plans and (iii) reduce commodity price risk associated with certain capital projects. During the three and six months ended June 30, 2007, the Company's commodity price hedges decreased oil and gas revenues from continuing operations by $18.1 million and $38.2 million, respectively, as compared to $26.7 million and $84.1 million during the same respective periods in 2006. The effective portions of changes in the fair values of the Company's commodity price hedges are deferred as increases or decreases to stockholders' equity until the underlying hedged transaction occurs. Consequently, changes in the effective portions of commodity price hedges add volatility to the Company's reported stockholders' equity until the hedge derivative matures or is terminated.

PIONEER NATURAL RESOURCES COMPANY

Deferred revenue. During the three and six months ended June 30, 2007, the Company's amortization of deferred VPP revenue increased oil and gas revenues from continuing operations by $45.4 million and $90.4 million, respectively, as compared to increases of $47.9 and $95.8 million during the same respective periods in 2006. See Notes F and L of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for specific information regarding the Company's VPPs.

Interest and other income. Interest and other income from continuing operations for the three and six months ended June 30, 2007 was $27.7 million and $41.6 million, respectively, as compared to $9.7 million and $22.9 million for the same respective periods in 2006. The $18.0 million increase in interest and other income from continuing operations during the three months ended June 30, 2007, as compared to the same period in 2006, was primarily due to the $25.0 million Alaskan PPT credit realized during the second quarter of 2007, partially offset by a $5.4 million decrease in interest income. The $18.7 million increase in interest and other income from continuing operations during the six months ended June 30, 2007, as compared to the same period in 2006, was primarily due to the aforementioned PPT credit, partially offset by a $3.6 million decrease in business interruption insurance recoveries and a $5.6 million decrease in interest income.

Oil and gas production costs. The Company recorded oil and gas production costs from continuing operations of $120.4 million and $224.8 million during the three and six months ended June 30, 2007, respectively, as compared to $103.1 million and $197.7 million for the same respective periods of 2006. In general, lease operating expenses and workover expenses represent the components of oil and gas production costs over which the Company has management control, while production and ad valorem taxes are directly related to commodity price changes and third-party transportation charges are related to volumes produced. Total oil and gas production costs per BOE from continuing operations increased by 9 percent during the three and six months ended June 30, 2007, as compared to the same respective periods in 2006, primarily due to continuing inflation of oilfield service costs and third-party transportation charges, as well as increases in United States ad valorem taxes due to overall commodity price increases. Also impacting the production costs for the three and six months ended June 30, 2007 are the (i) repair and clean-up costs, and associated production downtime, from severe weather conditions that affected certain areas of the Company’s United States operations during the first quarter of 2007 and (ii) costs of maintenance activities related to the compression facilities in the Raton field in Colorado.

The following tables provide the components of the Company's total oil and gas production costs per BOE from continuing operations and total oil and gas production costs per BOE from continuing operations by geographic area for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		**Six months ended June 30,**	
	2007	**2006**	**2007**	**2006**
Lease operating expenses	$ 7.09	$ 6.23	$ 6.90	$ 6.18
Third-party transportation charges	1.42	1.20	1.40	1.21
Taxes:				
Ad valorem	1.38	1.50	1.34	1.36
Production	1.63	1.78	1.64	1.77
Workover costs	1.01	0.74	0.93	0.73
Total production costs	$ 12.53	$ 11.45	$ 12.21	$ 11.25

PIONEER NATURAL RESOURCES COMPANY

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
United States	$ 11.97	$ 10.92	$ 11.61	$ 10.81
Canada	$ 16.90	$ 14.47	$ 17.99	$ 16.14
South Africa	$ 25.92	$ 22.00	$ 23.01	$ 16.15
Tunisia	$ 5.38	$ 0.71	$ 5.26	$ 2.07
Worldwide	$ 12.53	$ 11.45	$ 12.21	$ 11.25

Depletion, depreciation and amortization expense. The Company's total DD&A expense from continuing operations was $10.81 and $10.65 per BOE for the three and six months ended June 30, 2007, respectively, as compared to $9.78 and $9.70 per BOE during the same respective periods of 2006. Depletion expense from continuing operations, the largest component of DD&A expense from continuing operations, was $10.07 and $9.88 per BOE during the three and six months ended June 30, 2007, respectively, as compared to $9.17 and $9.05 per BOE during the same respective periods in 2006. The increases in per BOE depletion expense from continuing operations of 10 percent and nine percent during the three and six months ended June 30, 2007, respectively, as compared to the same respective periods in 2006, were primarily due to finding cost inflation. Per BOE depletion expense in South Africa during the six months ended June 30, 2007, as compared to the first six months ended June 30, 2006, decreased primarily due to positive proved reserve revisions.

The following table provides depletion expense per BOE from continuing operations by geographic area for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
United States	$ 9.66	$ 8.79	$ 9.49	$ 8.76
Canada	$ 17.62	$ 16.70	$ 17.28	$ 14.63
South Africa	$ 5.37	$ 4.45	$ 5.24	$ 7.42
Tunisia	$ 5.55	$ 4.79	$ 4.95	$ 4.87
Worldwide	$ 10.07	$ 9.17	$ 9.88	$ 9.05

Impairment of long-lived assets. During the three and six months ended June 30, 2007, the Company recognized an impairment charge of $17.9 million. Approximately $12.2 million of the impairment relates to the attempted divestiture of the Company's subsidiary that holds the interest in Block 320 in deepwater Nigeria. Additionally, $5.7 million relates to impairment of certain oil and gas properties located in the Company’s

onshore Gulf Coast area, as a result of poor well performance. See Note O of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information on the impairment charges.

PIONEER NATURAL RESOURCES COMPANY

Exploration and abandonments expense. The following tables provide the Company's geological and geophysical costs, exploratory dry hole expense, lease abandonments and other exploration expense from continuing operations by geographic area for the three and six months ended June 30, 2007 and 2006 (in thousands):

	United States	Canada	South Africa	Tunisia	Other	Total
Three months ended June 30, 2007:						
Geological and geophysical	$ 21,349	$ 2,894	$ 47	$ 298	$ 1,551	$ 26,139
Exploratory dry holes	2,373	1,154	—	5,057	15,554	24,138
Leasehold abandonments and other	10,008	1,866	—	—	7,639	19,513
	$ 33,730	$ 5,914	$ 47	$ 5,355	$ 24,744	$ 69,790
Three months ended June 30, 2006:						
Geological and geophysical	$ 11,962	$ 2,458	$ 47	$ 5,112	$ 4,404	$ 23,983
Exploratory dry holes	15,723	533	—	—	540	16,796
Leasehold abandonments and other	650	189	—	—	—	839
	$ 28,335	$ 3,180	$ 47	$ 5,112	$ 4,944	$ 41,618
Six months ended June 30, 2007:						
Geological and geophysical	$ 43,350	$ 3,948	$ 91	$ 576	$ 6,788	$ 54,753
Exploratory dry holes	41,387	3,692	—	7,608	15,562	68,249
Leasehold abandonments and other	12,645	2,876	—	—	7,639	23,160
	$ 97,382	$ 10,516	$ 91	$ 8,184	$ 29,989	$ 146,162
Six months ended June 30, 2006:						
Geological and geophysical	$ 32,622	$ 2,804	$ 130	$ 6,196	$ 13,687	$ 55,439
Exploratory dry holes	31,358	3,037	—	58	15,155	49,608
Leasehold abandonments and other	636	755	—	—	17,822	19,213
	$ 64,616	$ 6,596	$ 130	$ 6,254	$ 46,664	$ 124,260

The Company's exploration and abandonment expense from continuing operations during the second quarter of 2007 is primarily attributable to (i) continued seismic activity in the Company’s South Texas and Rocky Mountains plays, (ii) the $23.2 million dry hole and abandonment charge for the unsuccessful Ofuruma 1X well on the Devon Energy-operated Block 256 in deepwater Nigeria, (iii) $11.7 million of dry hole and abandonment charges associated with the Company’s exploration activities in the National Petroleum Reserve – Alaska (“NPRA”) on the North Slope of Alaska, (iv) a $5.1 million write off of previously suspended costs associated with an exploration well drilled during 2003 in the Tunisian Anaguid permit and (v) $2.6 million of Canadian dry hole and abandonment charges. During the first half of 2007, the Company drilled and evaluated 34 exploration/extension wells, 23 of which were successfully completed as discoveries. During the same respective period in 2006, the Company drilled and evaluated 213 exploration/extension wells, 201 of which were successfully completed as discoveries. The decline in the number of exploration/extension wells drilled by the Company is reflective of the Company’s significant reduction in its drilling in Canada, primarily in the Horseshoe Canyon area.

General and administrative expense. General and administrative expense from continuing operations for the three and six months ended June 30, 2007 were $30.8 million and $65.3 million, respectively, as compared to $29.5 million and $61.7 million during the same respective periods in 2006. The increase in general and administrative expense from continuing operations during the first six months of 2007, as compared to the first six months of 2006, was primarily due to increases in administrative staff and performance-related compensation costs, including the amortization of restricted stock awarded to officers, directors and employees. As of June 30, 2007, the Company has $54.2 million of deferred compensation expense related to unvested restricted stock awards that will be charged to earnings over a weighted average period of approximately one year and nine months. The Company continues to monitor its general and administrative expense and is focused on administrative cost control. However, the Company anticipates that the formation of Pioneer Southwest will necessitate future growth in the Company’s general and administrative expenses.

PIONEER NATURAL RESOURCES COMPANY

Interest expense. Interest expense from continuing operations was $30.5 million and $59.0 million for the three and six months ended June 30, 2007, respectively, as compared to $22.8 million and $59.3 million for the same respective periods in 2006. The weighted average interest rate on the Company's indebtedness for the three and six months ended June 30, 2007, including the effects of interest rate derivatives and capitalized interest, was 6.5 percent and 6.6 percent, respectively, as compared to 7.2 percent and 6.7 percent for the same respective periods in 2006. The increase in interest expense from continuing operations during the three months ended June 30, 2007, as compared to the same period of 2006, was primarily due to (i) a $12.6 million increase in interest incurred on senior note and credit agreement borrowings due to increased debt funding of additions to oil and gas properties and (ii) a $2.4 million increase in noncash interest expense attributable to certain discounted liabilities and deferred hedge losses, partially offset by (iii) a $7.3 million increase in capitalized interest on the Company's Oooguruk and South Coast Gas development projects in Alaska and South Africa, respectively. The Company expects interest expense to increase in future periods due to its large development projects nearing completion. The Company will cease its capitalization of interest costs incurred on the projects when they are completed, with the South Coast Gas project expected to be completed during the third quarter of 2007.

Hurricane activity, net. The Company recorded net hurricane related activity expenses of $47.0 million and $60.5 million during the three and six months ended June 30, 2007, respectively, and $38.0 million for the six months ended June 30, 2006, which are associated with the Company's East Cameron platform facility, located on the Gulf of Mexico shelf that was destroyed during 2005 by Hurricane Rita. The primary reason for the incremental increase in the reclamation and abandonment obligation in the second quarter of 2007 is the result of increases in the amount of time expected to complete certain aspects of the project based on the recent project work experience.

The Company does not plan to rebuild the facility based on the economics of the field. In January 2007, the operations to reclaim and abandon the East Cameron facility began and the Company expects to incur a substantial portion of the reclamation and abandonment costs in 2007. The Company recently commenced legal actions against certain of its insurance carriers regarding policy coverage issues. The Company continues to expect that a substantial portion of the loss will be recoverable from insurance. See Note N of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for specific information regarding the Company's East Cameron facility reclamation and abandonment.

Other expenses. Other expenses from continuing operations for the three and six months ended June 30, 2007 were $10.2 million and $18.6 million, respectively, as compared to $11.8 million and $16.8 million for the same respective periods in 2006. The Company's other expenses include legal and environmental contingency accruals, minority interests in earnings of subsidiaries, foreign exchange losses and other nonrecurring expenses.

Income tax provision. The Company recognized income tax provisions on continuing operations of $16.3 million and $32.2 million during the three and six months ended June 30, 2007, respectively, as compared to $50.2 million and $70.9 million for the same respective periods in 2006. The Company's effective tax rate on continuing operations of 31.8 percent and 33.1 percent during the three and six months ended June 30, 2007, respectively, differs from the combined United States federal and state statutory rate of approximately 37.0 percent primarily due to:

- foreign tax rates,
- statutes in foreign jurisdictions that differ from those in the United States, including a newly-enacted South African tax law allowing for the deduction of 150 percent of development expenditures resulting in a $5.2 million tax benefit recognized for the six months ended June 30, 2007,
- a $40.0 million tax benefit in the second quarter of 2007 related to the Company's plan to exit from Nigeria, as previously discussed,

- a $13.0 million U.S. tax provision in the second quarter of 2007 related to the Company no longer having identifiable plans to reinvest the South Africa earnings in South Africa, and
- changes in deferred tax asset valuation allowances.

See Note D of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information regarding the Company's income taxes.

PIONEER NATURAL RESOURCES COMPANY

Discontinued operations. During 2006, the Company sold its interests in the following oil and gas assets and has reflected their results of operations in discontinued operations:

Country	Description of Assets	Date Divested
United States	Deepwater Gulf of Mexico fields	March 2006
Argentina	Argentine assets	April 2006

The Company recognized income from discontinued operations of $1.6 million and $.9 million during the three and six months ended June 30, 2007, respectively, as compared to $22.2 million and $566.3 million for the same respective periods of 2006. The income from discontinued operation for the first half of 2006 includes the gains on the March 2006 disposition of the Company's deepwater Gulf of Mexico assets and the April 2006 disposition of the Company's Argentine assets. See Note P of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information regarding discontinued operations.

Capital Commitments, Capital Resources and Liquidity

Capital commitments. The Company's primary needs for cash are for development, exploration and acquisition of oil and gas properties, repayment of contractual obligations and working capital obligations. Funding for these cash needs, as well as funding for any stock repurchases that the Company may undertake, may be provided by any combination of internally-generated cash flow, proceeds from the disposition of nonstrategic assets or alternative financing sources as discussed in "Capital resources" below.

Oil and gas properties. The Company's cash expenditures for additions to oil and gas properties during the three and six months ended June 30, 2007, totaled $536.2 million and $974.8 million, respectively, as compared to $309.5 million and $644.4 million for the same respective periods of 2006. During the three and six months ended June 30, 2007, the Company's expenditures for additions to oil and gas properties were funded by $217.4 million and $347.4 million, respectively, of net cash provided by operating activities and borrowings on the Company's credit facility. During the three and six months ended June 30, 2006, the Company's additions to oil and gas properties were funded by $158.6 million and $476.9 million, respectively, of net cash provided by operating activities and a portion of the $1.6 billion of net proceeds received in conjunction with the March 2006 disposition of the Company's deepwater Gulf of Mexico assets (net of payments to terminate derivative instruments associated with the deepwater Gulf of Mexico assets) and the April 2006 disposition of the Company's Argentine assets.

Contractual obligations, including off-balance sheet obligations. The Company's contractual obligations include long-term debt, operating leases, drilling commitments, derivative obligations, other liabilities, transportation commitments and VPP obligations. From time-to-time, the

Company enters into off-balance sheet arrangements and transactions that can give rise to material off-balance sheet obligations of the Company. As of June 30, 2007, the material off-balance sheet arrangements and transactions that the Company has entered into included (i) undrawn letters of credit, (ii) operating lease agreements, (iii) drilling commitments, (iv) VPP obligations (to physically deliver volumes and pay related lease operating expenses in the future) and (v) contractual obligations for which the ultimate settlement amounts are not fixed and determinable such as derivative contracts that are sensitive to future changes in commodity prices. Other than the off-balance sheet arrangements described above, the Company has no transactions, arrangements or other relationships with unconsolidated entities or other persons that are reasonably likely to materially affect the Company's liquidity or availability of or requirements for capital resources. Since December 31, 2006, the material changes in the Company's contractual obligations included a $732.8 million increase in outstanding long-term borrowings, a $90.4 million decrease in the Company’s VPP obligations and a $52.1 million decrease in the Company's net derivative obligations. See Note E of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information regarding the Company's long-term debt and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" for a table of changes in the fair value of the Company's open derivative obligations during the six months ended June 30, 2007.

PIONEER NATURAL RESOURCES COMPANY

Environmental contingency. A subsidiary of the Company was notified by the Texas Commission on Environmental Quality ("TCEQ") in August 2005 that the TCEQ considered the subsidiary to be a potentially responsible party with respect to the Dorchester Refining Company State Superfund Site located in Mount Pleasant, Texas. In connection with the acquisition of oil and gas assets in 1991, the Company acquired a group of companies, one of which was an entity that had owned a refinery located at the Mount Pleasant site from 1977 until 1984. According to the TCEQ, this refinery was responsible for releases of hazardous substances into the environment. The TCEQ recently informed the Company that other previous owners and operators applied for acceptance into the Texas Voluntary Cleanup Program to clean up the site. As a result, the TCEQ deleted the site from the state Superfund registry and no longer considers the Company’s subsidiary a potentially responsible party with respect to the site. See Note I of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information regarding this matter as well as other environmental and legal contingencies involving the Company.

Capital resources. The Company's primary capital resources are net cash provided by operating activities, proceeds from financing activities and proceeds from sales of nonstrategic assets. The Company expects that these resources will be sufficient to fund its capital commitments during the foreseeable future. For 2007, the Company expects its capital commitments to exceed estimated cash flows from operations, resulting in additional borrowings under the Company's credit facility.

Asset divestitures. During the three and six months ended June 30, 2007, the Company received $13.3 million and $18.0 million of net proceeds from disposition of assets, the substantial portions of which included $12.0 million of proceeds from the sale of two drilling rigs during the second quarter of 2007 and the sale of an unproved domestic prospect during the first quarter of 2007. During March 2006, the Company sold all of its interests in certain oil and gas properties in the deepwater Gulf of Mexico for net proceeds of $1.2 billion, resulting in a gain of $726.1 million. The proceeds were reduced by $164.3 million of net payments to terminate derivative instruments associated with the deepwater Gulf of Mexico assets. During April 2006, the Company sold its Argentine assets for net proceeds of $669.6 million. The net proceeds from these 2006 divestitures were used to reduce outstanding indebtedness, to fund a portion of the Company’s 2006 additions to oil and gas properties, for stock repurchases and for general corporate purposes.

Operating activities. Net cash provided by operating activities during the three and six months ended June 30, 2007 was $217.4 million and $347.4 million, respectively, as compared to $158.6 million and $476.9 million for the same respective periods in 2006. The increase in net cash provided by operating activities during the second quarter of 2007, as compared to the second quarter of 2006, is primarily due to (i) increased sales volumes and increased NGL and gas prices realized from continuing operations, partially offset by increased production costs and (ii) the $25.0 million of income realized from Alaskan PPT credits. The decrease in net cash provided by operating activities during the first six months of 2007, as compared to the comparable period during 2006, was primarily due to 2006 net cash provided by operating activities associated with the divested deepwater Gulf of Mexico and Argentine assets.

Investing activities. Investing activities used $539.0 million and $986.4 million of cash during the three and six months ended June 30, 2007, respectively, and provided $343.5 million and $965.3 million of net cash for the same respective periods of 2006. The decrease in net cash provided by investing activities during the second quarter of 2007, as compared to the second quarter of 2006, is primarily due to the $679.4 million of net proceeds received from the divestiture of assets during the second quarter of 2006, a substantial portion of which resulted from the sale of the Company’s Argentine assets, and offset by a $226.6 million increase in additions to oil and gas properties. The decrease in net cash provided by investing activities during the first half of 2007, as compared to the first half of 2006, is primarily due to the $1.6 billion of net proceeds received from the divestiture of assets during the second quarter of 2006, a substantial portion of which resulted from the sale of the Company’s deepwater Gulf of Mexico and Argentine assets, and offset by a $330.4 million increase in additions to oil and gas properties during the comparable periods. The increase in additions to oil and gas properties is due to the timing of expenditures of the Company’s 2007 capital budget being heavily weighted to the first half of the year.

Financing activities. Net cash provided by financing activities during the three and six months ended June 30, 2007 was $333.1 million and $656.7 million, respectively, as compared to net cash used in financing activities of $90.3 million and $1.0 billion during the same respective periods in 2006. The increases in net cash provided by

45

financing activities during the three and six months ended June 30, 2007, as compared to the same periods of 2006, were due to net borrowings of long-term debt during the 2007 periods to fund portions of the Company’s additions to oil and gas properties, as compared to significant repayments of long-term debt during the 2006 periods from net proceeds from the divestitures of deepwater Gulf of Mexico and Argentine assets.

During February 2007, the Board declared a semiannual dividend of $.13 per common share payable to shareholders of record on March 30, 2007. Associated therewith, the Company paid $16.0 million of aggregate dividends during April 2007. Future dividends are at the discretion of the Board, and, if declared, the Board may change the current dividend amount in the future if warranted by future liquidity and capital resource attributes.

During February 2007, the Board also approved a share repurchase program authorizing the purchase of up to $300 million of the Company's common stock, which authorization the Board subsequently increased by $450 million during April 2007, for a total program of $750 million. During the three and six months ended June 30, 2007, the Company expended $22.8 million to acquire 469 thousand shares of treasury stock and $54.2 million to acquire 1.3 million shares of treasury stock, respectively. During the three and six months ended June 30, 2006, the Company expended $170.5 million to acquire 4.3 million shares of treasury stock and $172.4 million to acquire 4.4 million shares of treasury stock, respectively. As of June 30, 2007, approximately $702.2 million of treasury stock may be purchased in the future under the $750 million Board authorization.

During March 2007, the Company issued $500 million of 6.65% Notes for net proceeds of $494.2 million. The Company used the net proceeds from the 6.65% Notes to reduce indebtedness under its credit facility. During April 2007, the Company entered into the amended credit facility that extended the maturity of its credit facility to April 11, 2012. See Note E of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information regarding the significant terms of the amended credit facility.

On August 15, 2007, $32.1 million principal amount of the Company’s 8.25% senior notes mature and on January 15, 2008, $3.8 million principal amount of the Company’s 6.50% senior notes mature. The Company intends to fund the maturities of these senior notes with borrowings under its credit facility.

In July 2007, Pioneer Southwest filed a preliminary registration statement with the SEC to sell limited partner interests, which is subject to completion. Pioneer Southwest will own interests in certain oil and gas properties, which are currently owned by the Company, in the Spraberry field in the Permian Basin of West Texas. Pioneer Southwest expects to sell 44.4 percent (before underwriters’ over-allotment option) of its limited partner interests to the public (the “Offering”). Completion of the Offering is subject to market conditions and numerous other risks beyond the control of Pioneer Southwest, and therefore it is possible that the Offering will not be completed, will not raise the planned amount of capital even if the Offering is completed, or will not be completed when planned. If completed as planned, the Offering is estimated to result in the Company’s receipt of approximately $232 million of net cash proceeds during the second half of 2007.

PIONEER NATURAL RESOURCES COMPANY

As the Company pursues its strategy, it may utilize various financing sources, including fixed and floating rate debt, convertible securities, preferred stock or common stock. The Company may also issue securities in exchange for oil and gas properties, stock or other interests in other oil and gas companies or related assets. Additional securities may be of a class preferred to common stock with respect to such matters as dividends and liquidation rights and may also have other rights and preferences as determined by the Board.

Alaskan Petroleum Production Tax. In 2006, the State of Alaska replaced its severance tax with a new tax called the PPT, beginning in periods after March 31, 2006. The major components of the new PPT are:

- The "basic tax", which begins at 22.5 percent (this rate can increase based on factors tied to commodity prices) of property income for designated pools of assets in Alaska. Property income is basically defined as oil and gas revenue less lease operating expenses, qualified capital expenditures, property taxes and certain other costs. If property income is a loss then it converts to a PPT loss carryforward at a rate of 20 percent of the property income. PPT loss carryforwards can be used to reduce future PPT liabilities or transferred to a third party. For both the period in 2006 and the six months ended June 30, 2007, the Company estimates its PPT loss carryforwards to be approximately $21.0 million and $26.0 million, respectively.
- A capital expenditure credit of 20 percent of qualified capital expenditures within Alaska. The credit can be (a) used to reduce a company’s current PPT liability, (b) carried forward and used to reduce future PPT liabilities or (c) transferred to a third party. Certain qualified exploration capital expenditures can receive up to an additional 20 percent capital expenditure credit on the expenditures previously discussed. For 2006 and the six months ended June 30, 2007, the Company estimates its capital expenditure credits to be approximately $20.4 million and $33.6 million, respectively.
- Companies with production of less than 50,000 BOEPD within Alaska may also claim an annual non-transferable and non-refundable credit against PPT of $12 million per year for ten consecutive years, once the election is made to receive this credit.
- Companies that incurred qualified capital expenditures within Alaska in the five years preceding the PPT effective date can earn non-transferable transitional capital credits of 20 percent of such expenditures. These credits can be used to reduce a company’s present and future PPT liabilities. The Company estimates it has approximately $20 million of these credits to offset future PPT liabilities.

The Company currently has no production in Alaska and accordingly has no PPT liabilities. The Company anticipates that it will recognize benefits from the carryforwards and credits as they are used to reduce future PPT liabilities, sold to third parties or refunded by the State of Alaska. During the second quarter of 2007, the Company received $25.0 million of PPT credits through a refund from the State of Alaska, which amount has been recognized in interest and other income in the Company’s Consolidated Statements of Operations for the three and six months ended June 30, 2007. The Company may sell additional certificates in the future. Currently, the State of Alaska budgets annual amounts to provide for refunds of PPT credits; however, no assurances can be made that the State of Alaska will budget for future refunds. The Company cannot predict the price that a third-party would pay for the certificates, but anticipates that it will be at a discount to the face amount of the certificates.

Liquidity. The Company's principal source of short-term liquidity is cash on hand and unused borrowing capacity under the credit facility. There were $559.0 million of borrowings under the credit facility as of June 30, 2007. After deducting $115.4 million of undrawn and outstanding letters of credit under the credit facility, the Company had $825.6 million of unused borrowing capacity as of June 30, 2007. In the future, to the extent that Pioneer's liquidity results in cash in excess of immediate capital needs, the Company may repay indebtedness or invest the excess funds.

Debt ratings. The Company receives debt credit ratings from Standard & Poor's Ratings Group, Inc. ("S&P") and Moody's, which are subject to regular reviews. S&P’s rating for the Company is BB+ with a stable outlook. Moody's rating for the Company is Ba1 with a negative outlook.

S&P and Moody's consider many factors in determining the Company's ratings including: production growth opportunities, liquidity, debt levels and asset and reserve mix. A reduction in the Company’s debt ratings could negatively impact the Company's ability to obtain additional financing or the interest rate, fees and other terms associated with such additional financing. As of June 30, 2007, the Company was in compliance with all of its debt covenants.

PIONEER NATURAL RESOURCES COMPANY

Book capitalization and current ratio. The Company's book capitalization at June 30, 2007 was $5.3 billion, consisting of debt of $2.2 billion and stockholders' equity of $3.1 billion. The Company's debt to book capitalization increased to 42 percent at June 30, 2007 from 33 percent at December 31, 2006, primarily due to indebtedness which was used to fund the Company's additions to oil and gas properties. The Company’s debt to book capitalization at December 31, 2005 was 48 percent and decreased to 33 percent at December 31, 2006. The decrease is principally due to the reduction of debt from the application of the proceeds received from the divestiture of the deepwater Gulf of Mexico assets and Argentine assets in 2006. The Company's ratio of current assets to current liabilities was .68 to 1.00 at June 30, 2007 as compared to .60 to 1.00 at December 31, 2006.

New accounting pronouncement. In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). The Interpretation clarifies the accounting for income taxes by prescribing a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on measurement, classification, interim accounting and disclosure. The Company adopted FIN 48 on January 1, 2007 and recorded no adjustment related to the adoption. See Note D of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for additional information.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measures" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measures required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is continuing to assess the impact of SFAS 157.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). SFAS 159 permits entities to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The implementation of SFAS 159 is not expected to have a material effect on the financial condition or results of operations of the Company.

PIONEER NATURAL RESOURCES COMPANY

Item 3. **Quantitative and Qualitative Disclosures About Market Risk**

The following quantitative and qualitative disclosures about market risk are supplementary to the quantitative and qualitative disclosures provided in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. As such, the information contained herein should be read in conjunction with the related disclosures in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Although certain derivative contracts to which the Company has been a party did not qualify as hedges, the Company does not enter into derivative or other financial instruments for trading purposes.

The following table reconciles the changes that occurred in the fair values of the Company's open derivative contracts during the first half of 2007:

	Derivative Contract Net Liabilities (a)			
	Commodities	Interest Rate	Foreign Exchange Rate	Total
	(in thousands)			
Fair value of contracts outstanding as of December 31, 2006	$ (68,228)	$ —	$ —	$ (68,228)
Changes in contract fair value (b)	28,139	(1,537)	(64)	26,538
Contract maturities	(40,300)	—	64	(40,236)
Contract terminations	70,197	1,537	—	71,734
Fair value of contracts outstanding as of June 30, 2007	$ (10,192)	$ —	$ —	$ (10,192)

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(a) Represents the fair values of open derivative contracts subject to market risk. The Company also had $137.1 million and $131.1million of obligations under terminated derivatives as of June 30, 2007 and December 31, 2006, respectively, for which no market risk exists.

(b) At inception, derivative contracts entered into by the Company had no intrinsic value.

Foreign exchange rate sensitivity. From time to time, the Company's Canadian subsidiary enters into short-term forward currency agreements to purchase Canadian dollars with U.S. dollar gas sales proceeds. The Company does not designate these derivatives as hedges due to their short-term nature. There were no outstanding forward currency agreements at June 30, 2007 or December 31, 2006.

Interest rate sensitivity. See Note E of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" and Capital Commitments, Capital Resources and Liquidity included in "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" for information regarding debt transactions.

PIONEER NATURAL RESOURCES COMPANY

The following table provides information about other financial instruments to which the Company was a party as of June 30, 2007 and that are sensitive to changes in interest rates. For debt obligations, the table presents maturities by expected maturity dates, the weighted average interest rates expected to be paid on the debt given current contractual terms and market conditions and the debt's estimated fair value. For fixed rate debt, the weighted average interest rate represents the contractual fixed rates that the Company was obligated to periodically pay on the debt as of June 30, 2007. For variable rate debt, the average interest rate represents the average rates being paid on the debt projected forward proportionate to the forward yield curve for LIBOR on August 8, 2007. As of June 30, 2007, the Company was not a party to material derivatives that would subject it to interest rate sensitivity.

Interest Rate Sensitivity

Debt Obligations as of June 30, 2007

	Six months ending December 31,	**Year ending December 31,**						**Liability Fair Value at June 30,**
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**	**Total**	**2007**
	($ in thousands)							
Total Debt:								
Fixed rate principal maturities (a)	$ 32,075	$ 3,777	$—	$ —	$ —	$ 1,732,985	$ 1,768,837	$ 1,701,641
Weighted average interest rate	6.64%	6.56%	6.56%	6.56%	6.56%	7.00%		
Variable rate principal maturities	$ —	$ —	$—	$ —	$ —	$ 559,000	$ 559,000	$ 559,000
Weighted average interest rate	6.34%	5.94%	6.08%	6.28%	6.44%	6.60%		

(a) Represents maturities of principal amounts excluding (i) debt issuance discounts and premiums and (ii) net deferred fair value hedge losses.

Commodity price sensitivity. The following table provides information about the Company's oil and gas derivative financial instruments that were sensitive to changes in oil or gas price as of June 30, 2007. As of June 30, 2007, all of the Company's oil and gas derivative financial instruments qualified as hedges.

See Note F of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements" for information regarding the terms of the Company's derivative financial instruments that are sensitive to changes in oil or gas prices as well as hedge volumes and weighted average

prices by calendar quarter.

PIONEER NATURAL RESOURCES COMPANY

Oil and Gas Price Sensitivity

Derivative Financial Instruments as of June 30, 2007

	Six months ending December 31, 2007	Year ending December 31, 2008	2009	2010	Asset (Liability) Fair Value at June 30, 2007 (in thousands)
Oil Hedge Derivatives:					
Average daily notional Bbl volumes:					
Swap contracts (a)	5,000	13,500	6,000	4,000	$ (67,692)
Weighted average fixed price per Bbl	$ 69.55	$ 59.04	$ 70.47	$ 71.46	
Collar contracts (b)	5,000	—	2,000	—	$ (1,278)
Weighted average ceiling price per Bbl	$ 76.04	$ —	$ 76.50	$ —	
Weighted average floor price per Bbl	$ 63.00	$ —	$ 65.00	$ —	
Average forward NYMEX oil prices (c)	$ 71.91	$ 70.93	$ 70.53	$ 70.47	
Gas Hedge Derivatives:					
Average daily notional MMBtu volumes (d):					
Swap contracts (a)	225,000	44,973	—	—	$ 58,778
Weighted average fixed price per MMbtu	$ 7.71	$ 8.85	$ —	$ —	
Average forward NYMEX gas prices (c)	$ 7.05	$ 8.24	$ 8.58	$ 8.37	

(a) Subsequent to June 30, 2007, the Company (i) entered into additional oil swap contracts for 1,500 Bbls per day of the Company's August through December 2007 production at an average price of $73.00 per Bbl and 250 Bbls per day of the Company's 2008 production at an average price of $73.43 per Bbl and (ii) entered into additional gas swap contracts for 2,500 MMBtu per day of the Company's 2008, 2009, and 2010 production at average prices of $7.35, $7.55 and $7.33 per MMBtu, respectively.

(b) Subsequent to June 30, 2007, the Company entered into additional oil collar contracts for 3,000 Bbls per day of the Company's 2008 production at an average floor price of $65.00 per Bbl and an average ceiling price of $80.80 per Bbl.

(c) The average forward NYMEX oil and gas prices are based on August 8, 2007 market quotes.

(d) To minimize basis risk, the Company enters into basis swaps for a portion of its gas hedges to convert the index price of the hedging instrument from a NYMEX index to an index which reflects the geographic area of production. The Company considers these basis swaps as part of the associated swap and collar contracts and, accordingly, the effects of the basis swaps have been presented together with the associated contracts.

Natural gas liquids prices. There were no outstanding NGL hedge contracts at June 30, 2007. Subsequent to June 30, 2007, the Company entered into natural gas liquids swap contracts for 500 Bbls per day of the Company's 2008 production at an average price of $44.33 per Bbl and 500 Bbls per day of the Company's 2009 production at an average price of $41.75 per Bbl.

51

PIONEER NATURAL RESOURCES COMPANY

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. The Company's management, with the participation of its principal executive officer and principal financial officer, have evaluated, as required by Rule 13a-15(b) under the Securities Exchange Act of 1934 ("the Exchange Act"), the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this Report. Based on that evaluation, the principal executive officer and principal financial officer concluded that the design and operation of the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Changes in internal control over financial reporting. There have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's last fiscal quarter that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PIONEER NATURAL RESOURCES COMPANY

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is party to the legal proceedings that are described under "Legal actions" in Note I of Notes to Consolidated Financial Statements included in "Item 1. Financial Statements". The Company is also party to other proceedings and claims incidental to its business. While many of these matters involve inherent uncertainty, the Company believes that the amount of the liability, if any, ultimately incurred with respect to such other proceedings and claims will not have a material adverse effect on the Company's consolidated financial position as a whole or on its liquidity, capital resources or future annual results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Report, you should carefully consider the risks discussed in the Company's Annual Report on Form 10-K under the headings "Item 1. Business – Competition, Markets and Regulations", "Item 1A. Risk Factors" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk", which risks could materially affect the Company's business, financial condition or future results. Except as stated below, there has been no material change in the Company's risk factors from those described in the Annual Report on Form 10-K.

Formation of Master Limited Partnerships. In April 2007, the Company announced that it intended to form two new master limited partnerships, which will own interests in long-lived, low-decline oil and gas assets. Completion of this plan is subject to market conditions and numerous other risks beyond the control of the Company, and therefore it is possible that one or both of the master limited partnerships will not be formed, will not complete an offering of securities, will not raise the planned amount of capital even if an offering of securities is completed, and will not be able to complete its proposed actions on the timetable indicated. Furthermore, the structure, nature, purpose, proposed assets and liabilities, and proposed manner of offering of the master limited partnerships may change materially from those anticipated. In addition, the master limited partnerships, and therefore the Company's retained investment in those partnerships, will be subject to the risks normally attendant to businesses in the oil and gas exploration and production industry, including most of the same risks to which the Company is subject. The Company's announcement of its plans did not, and this risk factor does not, constitute an offer to sell or the solicitation of an offer to buy any securities. Any offers, solicitations of offers to buy, or any sales of securities of either master limited partnership will be made only in accordance with the registration requirements of the Securities Act of 1933 or an exemption therefrom.

These risks are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that it currently deems to be immaterial also may materially adversely affect the Company's business, financial condition or future results.

PIONEER NATURAL RESOURCES COMPANY

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The following table summarizes the Company's purchases of treasury stock during the three months ended June 30, 2007:

Period	Total Number of Shares (or Units) Purchased (a)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased As Part of Publicly Announced Plans or Programs	Approximate Dollar Amount of Shares that May Yet Be Purchased Under Plans or Programs
April 2007	587	$ 49.54	—	
May 2007	469,405	$ 48.53	469,200	
June 2007	91	$ 53.13	—	
Total	470,083	$ 48.53	469,200	$ 702,271,808

(a) Amounts include shares withheld to satisfy tax withholding on employees' share-based awards.

During February 2007, the Board approved a share repurchase program authorizing the purchase of up to $300 million of the Company's common stock. In April 2007, the Board approved an increase of $450 million to the existing share repurchase program bringing the aggregate authorized share repurchase program to $750 million. During the first half of 2007, the Company purchased $47.7 million of common stock pursuant to the 2007 program.

Item 4. Submission of Matters to a Vote of Security Holders

The Company's annual meeting of stockholders was held on May 16, 2007 in Irving, Texas. At the meeting, three proposals were submitted for a vote of stockholders (as described in the Company's Proxy Statement dated April 4, 2007). The following is a brief description of each proposal and results of the stockholders' votes.

Election of Directors. Prior to the meeting, the Board designated four nominees as Class I directors with their terms to expire at the annual meeting in 2009 when their successors are elected and qualified. R. Hartwell Gardner, Linda K. Lawson, Frank A. Risch and Mark S. Sexton were, at the time of such nomination and at the time of the meeting, directors of the Company. Each nominee was re-elected as a director of the Company, with the results of the stockholder voting being as follows:

	For	Authority Withheld	Abstain	Broker Non-Votes
R. Hartwell Gardner	107,390,272	901,877	—	—
Linda K. Lawson	107,406,657	885,492	—	—
Frank A. Risch	107,376,739	915,410	—	—
Mark S. Sexton	74,834,143	33,458,006	—	—

In addition, the term of office for the following directors continued after the annual meeting: James R. Baroffio, Edison C. Buchanan, Andrew D. Lundquist, Charles E. Ramsey, Jr., Robert A. Solberg and Jim A. Watson.

PIONEER NATURAL RESOURCES COMPANY

Ratification of selection of independent auditors. The engagement of Ernst & Young LLP as the Company's independent auditors for 2007 was submitted to the stockholders for ratification. Such engagement was ratified, with the results of the stockholder voting being as follows:

For	106,142,290
Against	1,989,304
Abstain	160,555
Broker non-votes	—

Approval of Amended and Restated Employee Stock Purchase Plan. The Amended and Restated Employee Stock Purchase Plan was submitted to the stockholders for approval. The plan was approved, with the results of the stockholder voting being as follows:

For	87,577,012
Against	2,640,589
Abstain	231,034
Broker non-votes	—

<u>Item 6.</u> **<u>Exhibits</u>**

Exhibits

10.1 (a)	Pioneer Natural Resources Company Employee Stock Purchase Plan (Amended and Restated Effective as of September 1, 2007).
31.1 (a)	Chief Executive Officer certification under Section 302 of Sarbanes-Oxley Act of 2002.
31.2 (a)	Chief Financial Officer certification under Section 302 of Sarbanes-Oxley Act of 2002.
32.1 (b)	Chief Executive Officer certification under Section 906 of Sarbanes-Oxley Act of 2002.
32.2 (b)	Chief Financial Officer certification under Section 906 of Sarbanes-Oxley Act of 2002.

(a) Filed herewith.

(b) Furnished herewith.

PIONEER NATURAL RESOURCES COMPANY

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereto duly authorized.

PIONEER NATURAL RESOURCES COMPANY

Date:	August 9, 2007	By:	/s/ Richard P. Dealy Richard P. Dealy Executive Vice President and Chief Financial Officer
Date:	August 9, 2007	By:	/s/ Darin G. Holderness Darin G. Holderness Vice President and Chief Accounting Officer

PIONEER NATURAL RESOURCES COMPANY

Exhibit Index

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(b) Furnished herewith.